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## CHRONICLES OF A FAILURE: FROM A RENEGOTIATION CLAUSE TO ARBITRATION OF TRANSNATIONAL CONTRACTS

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### ABSTRACT

The present paper recounts the various steps which parties to a transnational contract containing a renegotiation clause may need to go through, should the circumstances accounted for in the renegotiation clause come to existence. To this end, the article sets off from an outline of the most relevant structural features and functions of renegotiation clauses, and of the typical obligations which may derive therefrom.

Secondly, the paper's focus narrows down to the – by no means infrequent – case of failure to renegotiate in presence of an arbitration clause governing the parties' agreement. In the latter case, in particular, several possible solutions facing the arbitral tribunal are explored, even by making parallel reference to the powers of national judges in similar cases. Such discussion also tackles the problem of the possible recognition of an award containing an adaptation of the contract by the arbitral tribunal, pursuant to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Finally, possible criteria which the arbitral tribunal may resort to in the latter case are also explored. We conclude that it is not possible to give a clear-cut answer to the question of whether, given the insertion of a renegotiation clause in a long-term transnational contract, arbitration may then successfully make up for the parties' lack of agreement. To this end, it is in fact required that the parties' will, the applicable procedural law and the applicable substantive law all converge on enabling contract adaptation by arbitrators.

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*Luigi Russi*<sup>‡</sup>

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## I. INTRODUCTION

The fundamental tenet of the institution of contract is the aptitude for enabling cooperative solutions amongst economic operators. In fact, when an exchange takes place through a contract, a resource is transferred from one party to the other, and consent of both parties to such transfer generally guarantees that each participant gains from the exchange.

For instance, in a sales contract, the transferor receives a price, which exceeds the value she places on the transferred asset; meaning that the next best use she could make of it could not yield as high a payoff as that obtained by transferring the asset against the given price. In turn, the transferee obtains a positive net payoff by paying a certain price in exchange for the transferred resource, since the latter enables her to produce a greater amount of wealth than is given away to purchase said asset. In other words, contracts allow to "move a resource . . . from someone . . . who values it less to someone . . . who values it more [and]. . . . [C]ooperative surplus is the name for the value created by moving the resource to a more valuable use."<sup>1</sup>

The paradigm for this economic understanding of contract consists of on-the-spot transactions, in which the exchange is simultaneous. On the other hand, when the transfer of the relevant resource is delayed or protracted in time, the profitability of the transaction for either party may vary, depending on the possible alternative uses for the concerned asset (which may change over time). This problem is of paramount importance in the context of long-term supply contracts: when one party promises to provide the promisee with a given commodity over a specified period of time, the contract price may initially be deemed adequate by both parties. Subsequent changes in the economic context,<sup>2</sup> however, may affect the profitability of the transaction. This entails the risk that one of the parties be left with a losing contract, meaning a contract in which she no longer benefits from the terms of the exchange, since a resource is to be transferred at a price that is lower – for the supplier - or higher – for the transferee - than the value of the next best use she could make of it.

A solution to this problem, which is often resorted to in commercial contractual practice, is the drafting of a renegotiation clause in the supply contract, whereby in light of certain predetermined events – which account for possible changes in the relevant economic variables – parties are supposed to redefine certain aspects of their contractual relationship, in order to adapt it to the changed circumstances.

Just as often, parties also draft price indexation clauses as a means to allow for automatic adaptation of the contract price. These two types of clauses may also be combined, and the price indexation clause may itself be subject to renegotiation.

At any rate, human foresight is at best limited. In light of subsequent events which the price indexing formula could not have accounted for, the balance of the contract may be deeply undermined, leaving one party with a negative surplus.

In such cases, of course, the renegotiation clause could provide a "back door" to overcoming this alteration of the contractual balance. Often, however, a higher burden on one of the parties may result in unexpected profits to the other, which may in turn affect the willingness of the benefited party to negotiate.

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<sup>1</sup> R. COOTER & T. ULEN, *LAW & ECONOMICS* 75 (3rd ed. 2000), available at [http://works.bepress.com/robert\\_cooter/56](http://works.bepress.com/robert_cooter/56) (last visited Sept. 6, 2007).

<sup>2</sup> Such as increased scarcity of the resource for the supply of which a contract was made, or the discovery of new, more profitable uses which may be made of said resource.

Let us think, for instance, of a supply contract for resource  $\beta$ : if, following increased scarcity of such resource (unaccounted for in the price indexing formula), the supplier were to furnish a commodity which she could sell on the open market at a higher price, she would essentially obtain a smaller share of cooperative surplus. Symmetrically, however, the promisee would find herself benefiting from the contractual entitlement to a low-cost supply of resource  $\beta$ . This being the case, it can be sufficient to consider, in order to assess the difficulty of the renegotiation process, how the entitlement to a higher fraction of surplus as a result of the change in circumstances makes the promisee comparatively wealthier under the contract than she could have expected at the time of contracting. Such wealth differential with respect to this specific relationship may in turn affect her scale of preferred negotiation outcomes.<sup>3</sup> This could then possibly make it harder for parties to reach a new balance.

All in all, it is not improbable that both mechanisms established by a price indexation and a renegotiation clause may fail. In this situation, a practitioner might then have to come to terms with another provision that is even more common in transnational contractual practice: an arbitration clause.

In view of the foregoing, it can finally be clarified which issues have been addressed in this work. Our main aim has, in fact, been that of understanding what legal issues are at stake in the event of failure of the renegotiation process, in case parties were to resort to arbitration procedures.

To this end, it has been attempted to parallel the methodology of comparative statics, by considering separately the issues involved in the *ante*-litigation scenario, and those at stake upon the onset of litigation. To this end, Part I analyzes (a) the typical structure of renegotiation provisions as well as (b) the nature of the ensuing obligations of the parties, in order to define the general "equilibrium" of the parties' entitlements before any litigation arises.

On the other hand, Part II considers (a) the possible controversies that may arise in connection with a renegotiation provision, and, with special focus on their arbitral solution, the issues of (b) the power of the arbitral tribunal to adapt the contract upon failure of negotiations, as well as (c) the compatibility of the ensuing award with the New York Convention on the Recognition and Enforcement of Arbitral Awards.<sup>4</sup>

Finally, a comparative overview has been sketched with respect to (d) the conditions which the applicable substantive law requires to be met, in order to allow judicial and arbitral adaptation of contracts.

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<sup>3</sup> If one assumes preferences to be income-sensitive. See Guido Calabresi & Douglas A. Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1095 (1972) (explaining the concept in more depth than has been done here).

<sup>4</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2518, 330 U.N.T.S. 38, available at [http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII\\_1\\_e.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII_1_e.pdf) (last visited Sept. 6, 2007) [hereinafter New York Convention].

## II. ANTE-LITIGATION SCENARIO

### A. *Typical Structure of Renegotiation Clauses*

The above-referred characteristics of long term contracts qualify them as "obsolescing bargain[s]" in which the perceptions of the parties regarding the usefulness and profitability of the venture and their relative bargaining strengths undergo constant changes."<sup>5</sup>

In this context, international contractual practice has given birth to a number of different provisions, including - but not limited to - renegotiation clauses, aimed at introducing more flexibility in the contractual relationship, so as to ensure enduring profitability for both parties.<sup>6</sup>

As a consequence, it is important to draw a preliminary distinction. Renegotiation clauses are in principle susceptible of application to any part of a contract: there are no inherent limitations - aside from those agreed upon by the parties - that functionally restrict their scope. In this respect, they differ from automatic adjustment provisions - also called "correction clauses" (*Korrekturklausel*) - which rely on external measurable variables (e.g. the price of a certain commodity, minimum hourly wages or stock market indices) in order to instill in the contract an element of change: such reliance on quantitative data functionally limits their applicability to the determination of price or quantity. Secondly, whereas the latter directly affect the regulation of the contractual relationship, by automatically adjusting it to changed circumstances, renegotiation clauses merely outline "the procedure to be followed without any attendant obligation to achieve a specific result."<sup>7</sup>

Furthermore, automatic adjustment clauses usually serve to account for "normal, regular events, typical fluctuations in market prices, costs [and] demand."<sup>8</sup> Instead, renegotiation clauses are usually rooted in "extraordinary – and as such also unforeseeable – as well as [in] unexpected situations and developments,"<sup>9</sup> which is why they are sometimes attached to "correction clauses" in order to provide a "failsafe" mechanism in case of changes of such magnitude as to render the adaptation device unworkable.<sup>10</sup>

<sup>5</sup> Muthucumaraswamy Sornarajah, *Supremacy of the Renegotiation Clause*, 5 J. INT'L. ARB. 97, 108 (1988).

<sup>6</sup> See Norbert Horn, *Standard Clauses on Contract Adaptation in International Commerce*, in ADAPTATION AND RENEGOTIATION OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE, 121 ff. (Norbert Horn ed. 1985) (providing a classification of adaptation clauses).

<sup>7</sup> *Id.* at 129.

<sup>8</sup> Jürgen F. Baur, *Wirtschaftsklauseln [Commercial Clauses]*, in FESTSCHRIFT FÜR ERNST STEINDORFF [WRITINGS IN HONOR OF ERNST STEINDORFF] 509, 510 (Jürgen F. Baur, Peter K. Mailander, Klaus J. Hopt eds. 1990)

<sup>9</sup> *Id.* at 511.

<sup>10</sup> An example of this is offered by the provisions of an energy supply contract, quoted in a decision by the German Federal Court of Justice:

5. The bases for the determination [of the contract price] are the general economic conditions on January 1, 1969. A measure of these conditions are...the starting price of coal ( $K_o$ ) and ... the starting hourly wage ( $L_o$ ), which equal the price of coal and the hourly wage as of January 1, 1969. Should the [actual] price of coal or the [actual] hourly wage change upwards or downwards with respect to the above starting prices, the new [contract price] should be determined through the multiplication of the [original contract price] by factor  $f$ , yielded by the following formula:

$$f = (0.6 + 0.15 \frac{K}{K_o} + 0.25 \frac{L}{L_o})$$

Where...  $K$  = [actual] price of coal...,  $L$  = [actual] hourly wage....

...

### 1. Triggering Events

The essential focus of renegotiation clauses is on the change in *economic* circumstances and, more specifically, in those that have a bearing “on the actual contract, on the agreed goods, their price, their supply and sale.”<sup>11</sup>

In particular, renegotiation clauses should encompass negative variations in costs and profits, provided that such variations are unforeseeable. In favour of such construction, it has been observed how “[a] ... complete enumeration of all changes, that could affect the general economic conditions, lays beyond what is practically possible”<sup>12</sup> and that, in light of this, it would hinder the conclusion of long-term contracts to leave unforeseeable losses where they fall. In this respect, the very inclusion of a renegotiation clause should serve as an indicator that the latter distribution of risk is not what parties were looking for.

To make this point clearer, it can be useful to distinguish renegotiation clauses *stricto sensu* from *force majeure* or hardship clauses, that are often also included in long-term contracts.

*Force majeure* clauses “serve primarily as precautions against the risks posed by economic, political or social events unforeseeable at the time of contracting, though without the aim of ensuring or re-establishing the commercial equilibrium of contract.”<sup>13</sup> More specifically, *force majeure* usually encompasses events of a fundamental character which constitute a permanent or temporary impediment to performance, and their usual effect is relief from contractual liability for nonperformance. However, in long-term contracts, complete relief from the duty to perform may turn out as an inappropriate solution, in light of the complexity of the relationship - which makes it hardly replaceable - and of the costs and financial obligations already incurred by the parties. Hence, contracts often allow for an extension of the performance period, and may require parties to negotiate a solution to the state of stall, brought about by the “act of God”, with cancellation of the contract as an *extrema ratio*.

On the other hand, hardship clauses relate to events that render contractual performance not impossible, but burdensome for one party, to the point of reaching the “limit of sacrifice.” In this respect, the general solution is that of reinstating the economic equilibrium between parties’ obligations, and the typical mechanism to achieve this is the resort to renegotiation.<sup>14</sup>

In light of the above, it can be observed how “beneath this limit of unforeseeable fundamental change in the contractual basis, parties to international investment contracts can overcome the

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Should the pricing conditions change in such a way that these provisions on price did not account anymore for changes in the overall economic conditions, the parties will reach new agreements.... (Bundesgerichtshof [BGH][Federal Court of Justice] July 4, 1979, 24 Betriebs-Berater [BB] 1213, 1979 (F.R.G.)).

<sup>11</sup> Baur, *supra* note 8, at 512.

<sup>12</sup> *Id.*

<sup>13</sup> Klaus Peter Berger, *Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators*, 36 VAND. J. TRANSNAT'L. L. 1347, 1352 (2003), available at <http://law.vanderbilt.edu/journals/journal/36-04/BERGER.pdf> (last visited Sept. 6, 2007).

<sup>14</sup> On the distinction between *force majeure* and hardship clauses, see also MARTIN BARTELS, CONTRACTUAL ADAPTATION AND CONFLICT RESOLUTION 62-64 (1985) and WOLFGANG PETER, ARBITRATION AND RENEGOTIATION OF INTERNATIONAL AGREEMENTS 239 (2nd ed. 1995) (“Renegotiation clauses . . . [D]iffer from *force majeure* clauses (*strictu sensu*) because their conditions of application are less strict and because they are intended to lead to contract change and not its termination or suspension . . . [T]he treatment of renegotiation clauses neither should be assimilated with hardship clauses . . . [T]he scope of renegotiation clauses is considerably wider.”).

*pacta sunt servanda* principle only if the contract contains a renegotiation clause,”<sup>15</sup> since “[b]y agreeing to . . . [such] clause the parties have made it clear that the ‘fair distribution of performance and counter-performance’ throughout the duration of the contract is more important to them than legal certainty.”<sup>16</sup>

However, the foregoing conclusion does not *per se* mean that *any* unforeseeable change in circumstances, no matter how trivial, may give rise to a claim for renegotiation. As a matter of fact, changes in circumstances should trespass a threshold of relevance, so as to actually bring about a sensible alteration of the contractual distribution of surplus. The determination of such a threshold, however, is a question of fact to be decided on a case-by-case basis.<sup>17</sup>

In sum, it is possible to think of unforeseeable changes in circumstances as a *continuum* along which a specific threshold value separates those that do not give rise to a claim to renegotiate, from those that do, through an unfavorable modification of the contractual distribution of surplus after the occurrence of a shift in costs and/or losses. Between trivial changes - that do not give rise to any renegotiation claim - and self-defeating altruism - which forms the object of hardship provisions - lay those situations which the drafting of a renegotiation clause is specifically addressed to.

This consideration enables a better understanding of the reasons of the sometimes general and vague formulation of *triggering events*. As a matter of fact, parties may find it problematic to specifically define, and to agree upon, “when a change of circumstances and its impact is serious enough to trigger a renegotiation.”<sup>18</sup> The broader the formulation of the clause, however, the greater the risks of instability and frequent conflicts between the parties. Secondly, general review clauses may hinder the enforceability of the contract.<sup>19</sup> As a matter of fact, subjecting the contract to a general renegotiation clause may cast doubts on the parties’ intention to bind themselves or on the agreement being sufficiently definite to issue a claim for performance.

Notwithstanding this, a vague formulation of triggering events may have less serious repercussions, the narrower the object of the clause. For instance, review clauses limited to price or quantity restrict the relevant circumstances to be assessed in evaluating the seriousness of a claim for renegotiation. Further, renegotiation provisions coupled with automatic adjustment clauses can be construed so as to come into effect, only when the automatic adjustment

<sup>15</sup> Berger, *supra* note 13, at 1354. See also Horn, *supra* note 6, at 130 (“General review formulas may be used if the parties to a contract on long-term cooperation are concerned that the original equilibrium of rights and duties may be adversely changed by future developments which, however, do not qualify as *force majeure* or hardship.”).

<sup>16</sup> Baur, *supra* note 8, at 512. We wish to point out that, although the expression “fair distribution of performance and counter-performance” may hint to a conception of contract as a zero-sum game - which would contradict our stated premise that performance has different values to the parties, which is why they agree to the exchange - it should instead be interpreted so as to refer to the distribution of the contractual surplus between the contracting parties.

<sup>17</sup> See BGH, *supra* note 10, at 1214 (“The determination of this threshold value, until whose trespassing price fluctuations must be accepted, depends on the circumstances of the individual case.”) and Aluminium Co. Of America v. Essex Group Inc., 499 F. Supp. 53, 92 (W.D. Pa. 1980) [hereinafter *ALCOA v. Essex*] (“[T]he Court would suggest that four factors considered in this decision will likely prove to be of durable importance in deciding whether to modify contracts . . . (3) the existence of severe out of pocket losses . . .”).

<sup>18</sup> Berger, *supra* note 13, at 1363.

<sup>19</sup> See also Horn, *supra* note 6, at 130.

mechanism unduly burdens one of the parties, leaving her with a substantially lower share of surplus than she was entitled to at the outset of the contractual relationship.<sup>20</sup>

Yet, for fear of excessive uncertainty, many clauses are quite specific in the determination of triggering events. For instance, some contracts binding a private business organization and a State - with respect to the exploitation of the State's natural resources - referred to the company's profits reaching a certain level,<sup>21</sup> or to the recovery of investment costs by the private party.

Some agreements, instead, account for a periodic review mechanism, in which renegotiation is to occur at predetermined points in time. The distinctive feature of such clauses is that the triggering event is not bound to a change in the underlying economic circumstances and, hence, "the extent to which the contract will be changed, is independent from the triggering event."<sup>22</sup> Such provisions were first used in contracts between business organizations and States, in that they allowed the host country government to undergo "less political pressure to immediately alter agreements which its public considers to be inequitable."<sup>23</sup> Yet, they are also used today in contracts between private entities, in that, if negotiations are to take place at a given point in time, it will be harder to justify negotiations before that moment.

## 2. *Other Possible Structural Elements of Renegotiation Clauses*

In order for renegotiations clauses to be effective, it has been just pointed out how some indication of a triggering event is indispensable, failing which, questions of contract validity might arise. There are, however, further elements which may be included in a renegotiation clause; of course, the more precise the drafting of such provision, the easier will it be to ascertain whether renegotiation is to occur, and how the review process should be carried out.

In particular, it has already been hinted throughout how review clauses may be restricted in their scope to specific contractual provisions, such as price or quantity (or, in State contracts, the fiscal regime to be applied to the private party's earnings), rather than to the whole contract.

Further, parties may wish to limit their discretion within the negotiation process. For instance, they might indicate

- a) criteria or parameters which they are to refer to in reviewing their respective obligations, or
- b) the purposes which the renegotiation process is to fulfill. In particular, such purposes may be formulated in either an objective, practical manner (e.g. the preservation of the financial equilibrium) or they may instead refer to subjective standards (for instance "fairness").

### *B. Obligations Stemming from a Renegotiation Clause*

Whenever a triggering events occurs, it has to be understood what is the precise content of the parties' obligations. To this end, however, it becomes necessary to make a few preliminary

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<sup>20</sup> See BGH, *supra* note 10 and Oberlandesgericht [OLG][trial court for selected criminal matters and court of appeals] April 4, 1980, 3 Zeitschrift für Wirtschaftsrecht [ZIP] 283, 1981 (F.R.G.) (dealing with generally formulated renegotiation provisions of automatic price adjustment formulas).

<sup>21</sup> See BARTELS, *supra* note 14, at 66 ("However, this can result in fundamental changes to the economic strategy, and run counter to the interests of all participants.").

<sup>22</sup> PETER, *supra* note 14, at 244.

<sup>23</sup> BARTELS, *supra* note 14, at 66.

considerations, since, in order to ascertain the precise effect of renegotiation provisions, an understanding of their intrinsic aim serves as an essential prerequisite.

### 1. *The Recognised Function of Renegotiation Clauses*

In the preceding discussion on renegotiation clauses, it has been pointed out how their recognised practical function is precisely that of preserving the balance, in the division of surplus, between the parties, over a lengthy period of time. In other words, the aforementioned aim is that pursued by the vast majority of parties deciding to include renegotiation or review clauses in their contractual agreements.

This conclusion may also be attained by referring to the common understanding of such clauses within the relevant literature.<sup>24</sup> Moreover, the same position has also been affirmed by arbitral tribunals, such as that of the so-called *Aminoil* arbitration, stating that the idea that

[T]he original equilibrium will be modified in favour of another equilibrium deemed equally equitable . . . [R]ests on the implied concept of a progressive process of justice revealing itself in the course of a sufficiently general historical evolution to be recognized for what it is by the parties. This is how they can be said to have based themselves in advance on the assumption that a division of profits equitable today will need to be modified in order still to be regarded as equitable tomorrow.<sup>25</sup>

Similarly, another arbitral tribunal stated that

Every commercial transaction is based on the balance of reciprocal performances and denying this principle would end up rendering the commercial contract an aleatory contract, founded on speculation or risk. It is a rule of *lex mercatoria* that [performance and counter-performance] remain balanced on the financial level, and that's why "the price is therefore fixed as a function of the conditions existing at the moment of the conclusion of the contract and varies according to parameters mirroring the variations in value of the different elements composing the product or performance."<sup>26</sup>

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<sup>24</sup> See Sornarajah, *supra* note 5, at 108 ("The aim of the renegotiation clause is to provide an opportunity for the parties to restore the contractual equilibrium if previously identified triggering events occur."); Piero Bernardini, *The Renegotiation of the Investment Contract*, 13 ICSID REVIEW – FOREIGN INVESTMENT L.J. 411, 419 (1998) ("[T]he provisions aiming at preserving the *economic equilibrium* of the investment agreement impl[y] that whenever the conditions are met for [their] application a negotiation phase is open for the parties . . ."); NAGLA NASSAR, SANCTITY OF CONTRACTS REVISITED 182 (1995) ("[T]he original equilibrium is to be modified in favour of a new one that is deemed equally equitable."); Horn, *supra* note 6, at 130 ("[R]evue formulas may be used if the parties to a contract on long-term cooperation are concerned that the original equilibrium of rights and duties may be adversely changed by future developments which, however, do not qualify as *force majeure* or hardship."); Berger, *supra* note 13, at 1363 ("[I]t must be assumed that, unless there are indications to the contrary, the parties always . . . wish to preserve the equilibrium of their contractual obligations as expressed in the contract."); Baur, *supra* note 8, at 516 ([T]he aim of commercial clauses is the restoration of the contractually established equilibrium between performance and counter-performance.")(citations omitted).

<sup>25</sup> Kuwait v. Am. Indep. Oil Co., 21 I.L.M. 976, §20, at 1003, (1982) [hereinafter *Aminoil*].

<sup>26</sup> ICC Award no. 2291 (1975), reprinted in SIGVARD JARVIN & YVES DERAIS, COLLECTION OF ICC ARBITRAL AWARDS: 1974-1985, at 274, 275 (1990) (citing Philippe Kahn, *Lex mercatoria et pratique des contrats internationaux : l'expérience française [Law Merchant and the Practice of International Contracts : the French experience]*, in LE CONTRAT ÉCONOMIQUE INTERNATIONAL. STABILITÉ ET ÉVOLUTION [THE INTERNATIONAL ECONOMIC CONTRACT : STABILITY AND EVOLUTION] 171 (Lázló Réczéi ed. 1975)). We wish to point out how,

With reference to the latter statement, however, we wish to leave aside the question of the nature of *lex mercatoria* as an autonomous binding legal system, which is – to say the least – problematic, in that it is debated whether the latter fulfils the requirements of “relative predictability, authoritativeness and consistency”<sup>27</sup> that are implicit in the definition of legal system. At any rate the considerations made by the cited arbitral tribunal still do prove meaningful, if one considers them as an explication of “generally followed trade usages”<sup>28</sup>

By now, it should then be clear how renegotiation clauses are regarded, within the international commercial community, as mere adjustment mechanisms that, as such, simply serve the function of restoring the *status quo* – in terms of distribution of surplus – within new economic circumstances. In the words of one commentator,

[T]he function of these clauses is limited to adapting the contract to the changed circumstances. They do not justify a restructuring of the entire contract . . . . Renegotiation clauses should not result in a commercial advantage to one of the parties, but instead, function either to maintain or to restore the commercial balance of the contract to adjust to changed circumstances.<sup>29</sup>

## 2. *Relevance of Trade Usage in Interpreting Renegotiation Clauses*

In view of the foregoing, it remains to clarify what bearing such a widely accepted understanding of the function of renegotiation clauses - in terms of mere re-equilibration of the contract’s burdens and gains - has with respect to the determination of their legal effects. As a matter of fact, “the *lex mercatoria* [understood in terms of generally adopted trade practices] consists of binding usage and depends in the last resort on recognition by national law.”<sup>30</sup>

To this end, an essential role is played by the rules on interpretation. Most legal systems, in fact, allow legal operators to resort, under certain circumstances, to so-called objective criteria of interpretation. Such criteria are usually aimed at ascertaining the “meaning which would be given [to the contract] by a reasonable man, supposing him to be in the situation of the addressee and to understand the words used in the context of all the other relevant circumstances of which he could have been aware . . . . In making this determination ‘due consideration is to be given to all relevant circumstances of the case, including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.’”<sup>31</sup>

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although the language used by the arbitral tribunal may appear misleading, in that it appears to imply a conception of contract as a zero-sum game, the principle expressed may still hold true with reference to the balance in the distribution of contractual surplus.

<sup>27</sup> Keith Highet, *The Enigma of Lex Mercatoria*, 63 TUL. L. REV. 613, 625 (1989).

<sup>28</sup> ICC Award no. 2291, *supra* note 26, at 275.

<sup>29</sup> Berger, *supra* nota 13, at 1365.

<sup>30</sup> Roy Goode, *Rule, Practice, and Pragmatism in Transnational Commercial Law*, 54 INT’L & COMP. L. Q. 539, 549 (2005).

<sup>31</sup> I HEIN KÖTZ, EUROPEAN CONTRACT LAW 109 (Tony Weir trans. 1997) (citing United Nations Convention on Contracts for the International Sale of Goods, art. 8(3), April 11, 1980, 1489 U.N.T.S. 3 [hereinafter CISG] ). See BÜRGERLICHES GESETZBUCH [BGB] § 133 (F.R.G.) (“Contracts should be interpreted in accordance with the dictates of good faith in relation to good commercial practice.”); ALLGEMEINES BÜRGERLICHES GESETZBUCH [ABGB] § 914 (Austria) (“In the interpretation of contracts one is not to stop at the literal meaning of the expression, but . . . to understand the contract, after sound business practice.”); CODICE CIVILE [C.C.] art. 1368 (Italy) (“Ambiguous clauses are to be interpreted after the general usage of the place where the contract has been entered into.”); U.C.C. § 1-303(d) (2001) (“A course of performance or course of dealing between the parties or usage of trade in the vocation

Incidentally, it must be pointed out how a subjective interpretive criterion also exists, aiming to ascertain the actual intentions of the parties.<sup>32</sup> In particular, this rule comes into play in order to overcome the literal wording of the contract, whenever it is evident that parties attached the same stipulated meaning to it. Nonetheless, it is submitted that such a rule would hardly be of use in interpreting renegotiation clauses, whose formulation might often be wide and open to interpretation, to the point of precluding the possibility of enucleating a single, common intention of the parties valid for each particular case.

In light of this, the objective criterion of interpretation plays the leading role in clarifying the meaning of renegotiation clauses, whenever parties disagree over their correct interpretation. Furthermore, such a criterion allows to refer back to the general understanding of their function (*i.e.* restoration of original equilibrium in the distribution of surplus), as adopted by trade practice, that in turn acquires legal relevance as to the determination of the clause's effect.

### 3. *Implication of Trade Usage in Supplementing Renegotiation Clauses*

Interpretation, however, is theoretically limited to the clarification of ambiguous expressions. In other words, in order to ascribe to a renegotiation clause the function of reequilibrating contractual surplus distribution, parties should have included at least some broad indication of the goals of renegotiation.

Lacking any such indication, implication is another tool through which the general understanding of the function of review provisions may supplement the contractual agreement, and provide guidance to the purpose of ascertaining the precise effects of a renegotiation clause.

To this end, there are many examples of norms allowing one to resort to trade practices in order to supply missing terms to the parties' agreement.<sup>33</sup>

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or trade in which they are engaged or of which they are or should be aware is relevant in ascertaining the meaning of the parties' agreement."). Furthermore, even in jurisdictions where interpretation of contracts should be essentially guided by the subjective criterion of the "common intention of the parties," as in France, "a judge will hardly ever be able to discern any real historical intention of the parties, so he will inevitably have regard to 'objective' considerations, that is, ask how in the light of all the circumstances a reasonable man would normally understand what was said." (1 HEIN KÖTZ, 111).

<sup>32</sup> See CODE CIVIL [C.CIV.] art. 1156 (Fr.) ("One must in agreements seek what the common intention of the contracting parties was, rather than pay attention to the literal meaning of the terms."); BGB § 133 ("In interpreting a declaration of will one should look for the actual will rather than stopping at the literal meaning of the expression."); C.C. art. 1362 ("In interpreting the contract one has to inquire about the common intention of the parties rather than limiting oneself to the literal meaning of words"); Schweizerisches Obligationenrecht [OR][Law of Obligations] Mar. 30, 1911, SR 220, art. 18 (Switz.) ("To appreciate the form and the clauses of a contract, one has to inquire about the real and common intention of the parties, without stopping to the wrong expressions or denominations they may have relied upon, either by mistake, or in order to disguise the true nature of the agreement."); ABGB § 914 ("In the interpretation of contracts one is not to stop at the literal meaning of the expression, but to inquire about the intention of the parties."); Restatement (Second) of Contracts §201(1) (1981) ("Where the parties attach the same meaning to the terms used in their agreement, the interpretation of the agreement should be in accord with that meaning even if a third party might interpret the language differently."); *Adamastos Shipping Co. v. Anglo-Saxon petroleum Co.*, [1959] A.C. 133, 150 (H.L.) (appeal taken from Eng.) (U.K.) ("Commercial men are often slapdash and the courts construe their contracts with an eye to the intention of the parties. The intention is deduced from the words used and from the surrounding circumstances").

<sup>33</sup> U.C.C. § 1-303(d) ("A course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware . . . may supplement or qualify the terms of the agreement."); C.C. art. 1374 ("The parties are bound not only by the contract, but also to the consequences stemming from the law or, in its absence, from usages or equity") (Commonly interpreted so as to refer to the filling of contractual gaps by way of default provisions; see II VINCENZO ROPPO ET AL., TRATTATO DEL CONTRATTO [TREATISE ON CONTRACT] 390 (2006)); C. CIV. art. 1135 ("Agreements are binding not only as to what

The general supplementing function of trade usage is also contemplated in the procedural rules for arbitration issued by the International Chamber of Commerce, where it is stated that "[i]n all cases the Arbitral Tribunal shall take account of the provisions of the contract and the relevant trade usages,"<sup>34</sup> regardless of the applicable substantive law. Finally, although with limited practical relevance (unless the parties expressly subjected the contract to them), it is possible to mention the provisions of private restatements of contract law, such as the UNIDROIT Principles of International Commercial Contracts<sup>35</sup> or the Principles of European Contract Law.<sup>36</sup>

#### 4. *The Effects of a Renegotiation Clause*

In the preceding three subsections, it has been first pointed out how the generally understood function of renegotiation clauses is limited to contract adaptation, which precludes the possibility to restructure the whole contract. Second, it has been observed how such widespread understanding may be regarded as a usage to resort to in order to interpret or supplement the contractual agreement. Conclusively, then, unless express indications to the contrary are included in the contract, renegotiation clauses *should* always be interpreted in conformity with the general understanding of their function in international trade practice.

In light of this, it becomes possible to provide practical content to the legal effects of a renegotiation clause, since, "[i]ndependent of the formulation of each clause, a catalogue of more or less concrete party obligations can be derived from the inherent function of this type of clause which must be fulfilled in a renegotiation procedure."<sup>37</sup>

First of all, however, it should be pointed out that, in order for the clause to impose any obligation upon the parties, an intention to do so must be apparent from its very formulation. In particular, several authors have ruled out clauses too vaguely worded, such as those providing that the contract may be modified by the parties in written form. "Parties to contracts containing such clauses are *de jure* under no duty to initiate the renegotiation process, which is conditioned upon the agreement of both parties to review their relationship."<sup>38</sup>

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is therein expressed, but also as to all the consequences which equity, usage or statute give to the obligation according to its nature.") and 1160 ("Terms which are customary shall be supplemented in the contract, even though they are not expressed there"); CISG, *supra* note 31, art. 9 ("(1) The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves. (2) The parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.")

<sup>34</sup> ICC RULES OF ARBITRATION art. 17 (1998), available at [http://www.iccwbo.org/court/english/arbitration/pdf\\_documents/rules/rules\\_arb\\_english.pdf](http://www.iccwbo.org/court/english/arbitration/pdf_documents/rules/rules_arb_english.pdf) (last visited Sept. 6, 2007).

<sup>35</sup> UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS art. 1.9 (2004) [hereinafter UNIDROIT Principles], available at <http://www.jus.uio.no/lm/unidroit.international.commercial.contracts.principles.2004/portrait> (last visited Sept. 6 29, 2007) ("(1) The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves. (2) The parties are bound by a usage that is widely known to and regularly observed in international trade by parties by parties in the particular trade concerned except where the application of such a usage would be unreasonable.").

<sup>36</sup> PRINCIPLES OF EUROPEAN CONTRACT LAW art 1:105 [hereinafter PECL], available at <http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/portrait> (last visited Sept. 6, 2007) ("(1) The parties are bound by any usage to which they have agreed and by any practice they have established between themselves. (2) The parties are bound by a usage which would be considered generally applicable by persons in the same situation as the parties, except where the application of such usage would be unreasonable.").

<sup>37</sup> Berger, *supra* note 13, at 1364

<sup>38</sup> NASSAR, *supra* note 24, at 177. See also BARTELS, *supra* note 14, at 59.

Save for such limit cases, however, it is generally recognized that renegotiation clauses give rise to a duty to negotiate, albeit not to reach any specific agreement. In fact, "[a]ccording to unanimous international opinion, renegotiation clauses only contain an obligation on the parties to make the best possible effort to reach an agreement . . . . They do not, however, require the parties to actually reach an agreement."<sup>39</sup>

In particular, renegotiations should be carried out in good faith to the purpose of reaching a new balance as to the distribution of contractual surplus. To put it in a general clause, "the parties are expected to take negotiation seriously and to consider each other's position with an ability to compromise, for, otherwise, negotiation would be futile."<sup>40</sup>

One commentator has even attempted to list some conducts which should be adopted by the parties in the course of renegotiation.<sup>41</sup> However, this very commentator also recognized how "[w]ithin a given renegotiation process, none of these obligations have sole validity. Rather, they are starting points for determining what is required of the parties in each individual case . . . . [S]ubject to the principle of good faith and, in particular, the notions of fairness and reasonableness derived therefrom."<sup>42</sup>

It can ultimately be seen how the whole process of determining what good faith performance of the renegotiation duty consists of, hinges precisely on the meaning of "good faith." In this respect, a criterion which has been articulated by the Law and Economics literature<sup>43</sup> may prove useful. It lays beyond the scope of this paper to deal in depth with the theoretical foundations of such criterion. However, it might be useful to briefly introduce it, for the practical guidance it might provide to parties in fashioning their behavior in the performance of the renegotiation duty. As a matter of fact, cooperation can be regarded as an incremental process, in which each party takes one step at a time. Good faith would then require each party to cooperate until each incremental step disclosed higher gains to the other party (or, for that matter, to both) than it cost the cooperating party to adopt it, in terms of foregone opportunities. For instance, let us imagine

<sup>39</sup> Berger, *supra* note 13, at 1367. See also PETER, *supra* note 14, at 247 and Jeswald W. Salacuse, *Renegotiating International Project Agreements*, 24 FORDHAM INT'L. L.J. 1319, 1334 ("An intra-deal renegotiation clause obliges the parties only to negotiate, not to agree. If the parties have negotiated in good faith pursuant to the clause but fail to reach agreement, the failure cannot justify liability on the part of one of the parties."). Arbitral case-law also contains some statements in this respect, see Aminoil, *supra* note 25, §24, at 1004 ("An obligation to negotiate is not an obligation to agree. Yet the obligation to negotiate is not devoid of content, and when it exists within a well-defined juridical framework it can well involve fairly precise requirements. In some cases the failure of the negotiations can be attributed to the conduct of one of the parties, and if so, the matter becomes transposed onto the plane of responsibility, and must find its solution there.")

<sup>40</sup> NASSAR, *supra* note 24, at 180.

<sup>41</sup> Berger, *supra* note 13, at 1365. ("1. Keeping to the negotiation framework set out by the clause, 2. Respecting the remaining provisions of the contract, 3. Having regard to the prior contractual practice between the parties, . . . 5. Paying attention to the interests of the other side, 6. Producing information relevant to the adaptation, . . . 12. Giving appropriate reasons for one's own adjustment suggestions, . . . 15. Making an effort to maintain the price-performance relationship taking into consideration the parameters regarded as relevant by the parties, 16. Avoiding an unfair advantage or detriment to the other side ('no profit – no loss' principle) . . .")

<sup>42</sup> *Id.* at 1366 (notes omitted).

<sup>43</sup> See generally Alberto Monti, *Learned Hand Formula e Buona Fede nell'Esecuzione del Contratto. Analisi Economica e Comparata* [*Learned Hand Formula and Good Faith Performance: Economic and Comparative Analysis*], 16 RIVISTA CRITICA DEL DIRITTO PRIVATO [RIV. CRIT. DIR. PRIV.] 125 (1998) (Italy), Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980), Steven J. Burton, *Good Faith in Articles 1 and 2 of the UCC: the Practice View*, 35 WM AND MARY L. REV. 1561 (1994), Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND.L.J. 45 (1995), Luigi Russi, *Can Good Faith Performance be Unfair? An Economic Framework for Understanding the Problem*, 29 WHITTIER L. REV. 565 (2008).

the case in which the cost for the supplier to carry out a supply contract had increased up to the point of escaping all contractually agreed indexes for automatic adaptation. Good faith negotiation would require the promisee to agree to a higher price, as long as each additional increase in cooperation disclosed higher aggregate incremental benefits (for instance, if the cost of making an additional price concession to one party were lower than the decreased likelihood that the supplier would go out of business, “weighed” by the discounted cash flow of future earnings enabled by its enduring presence on the marketplace).

It follows from the existence of such a duty to renegotiate in good faith, that were a party

- a) to refuse to enter negotiations, despite the existence of a triggering event or
  - b) to take insufficient cooperative steps *vis-à-vis* the standard set by good faith,
- it should be considered in breach of the renegotiation duty, and hence liable for damages.<sup>44</sup>

Finally, it remains to be clarified how the contractual equilibrium - whose preservation renegotiation clauses are aimed at – should be understood. As has been anticipated in the introduction, the stipulation of a contract provides one of the partes with an asset, which the latter ascribes a certain value (V) to. In the case of a supply contract, for instance, the value of the supplied asset to the receiving party might be indirectly determined by observing the price which the asset is resold at, on the retail market. Symmetrically, the stipulation of a contract also causes the counter-party to bear certain costs (C) to deliver performance. The gain (G), or surplus, arising from cooperation hence amounts to  $G = V - C$ .

In light of this, the fraction of gain or surplus that each party receives depends on the level at which the contract price is fixed. "The division of bargaining power between the parties is such that if they have to reach an agreement to create a surplus, they will divide it so that the buyer is expected to get a fraction  $\theta$  of the surplus... and the seller is expected to get a fraction  $1 - \theta$  of the surplus."<sup>45</sup>

From the above considerations follows that renegotiation should ideally require the parties to perform a confrontation between total gain (G)

- a) at the time of the execution of the contract and
- b) at the time of renegotiation,

and to ascertain to what percentage the surplus ( $\theta$ ) had been entitled to either party. Hence, the limit to the adjustments parties may make to the contractual agreement will then consist in the achievement of a new distribution of surplus, proportional to the original one.

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<sup>44</sup> On the amount of damages that could be awarded, see Berger, *supra* note 13, at 1369 ("If one were to grant the party a claim for damages for non-performance, the arbitral tribunal would have to compare the situation which has arisen with a possible successful negotiation outcome. In this way, the tribunal would be forced indirectly, i.e. via the calculation of damages, actively to structure the agreement. For this reason, such an approach is not practicable. Therefore, only classic damages from delay and costs incurred in reliance on reaching an agreement are recoverable.").

<sup>45</sup> Lucian Arye Bebchuk & Omri Ben-Shahar, *Precontractual Reliance*, 30 J. LEGAL STUD. 423, 430 (2001).

### III. *POST-LITIGATION SCENARIO*

#### A. *Possible Disputes*

The road to the achievement of a successful renegotiation is paved with difficulties. As an example, one may think of transaction costs. Good faith negotiation requires, in fact, to consider the incremental benefits of each cooperative step; to estimate which, however, parties have to gather information at a cost, which in turn raises the burdens connected to the adoption of the cooperative step. In other words, it is possible that parties may legitimately come to end negotiations without any breach of the good faith principle. Further, there may be strategic difficulties to the achievement of a new agreement. Each party may, in fact, have an incentive to over-represent her possible losses, or to understate her expected gains, so as to obtain as many concessions as possible. The other party might then, in turn, adjust her cooperative efforts, so as to account for this probability that the counter-party over- or understates, to her benefit, the values relevant to the renegotiation process. If overdone, the adoption of such an attitude could lead to the (bad faith) failure of renegotiations. However, before disagreeing on the outcomes of negotiation, parties will also have to agree on several other issues, first and foremost the actual occurrence of a triggering event.

In light of these considerations, it is possible to distinguish between several possible “failing” outcomes. Generally speaking, one can distinguish three principal categories of disputes, which a renegotiation clause may give rise to:

- a) first of all, parties may disagree over the correct interpretation of the clause. For instance, they might have different views as to whether a triggering event has in fact occurred, based on the formulation of the review provision. Another example could be the disagreement over “the terms and conditions which should be made subject to revision and the extent of such revision;”<sup>46</sup>
- b) further yet, one of the parties may request damages to the other one, claiming that negotiation has not been carried out in good faith on the latter’s part (failure due to the parties’ gross over- or understatement of relevant values might, for instance, fall in this category);
- c) finally, where the parties, despite negotiating in good faith, find it impossible to overcome their differences and to succeed in reestablishing the contractual equilibrium, negotiations will fail absent any liability on either side, having the good faith negotiation obligation been fulfilled.

With respect to lack of agreement on the precise direction of contract adaptation, it has to be pointed out how “even the failure of the consensus procedure where one party is at fault will not change the original contractual distribution of risk. The contract remains in force, unless the parties have determined otherwise in the clause or have clearly expressed . . . that the validity of the contract is restricted to the circumstances as they existed at the time of concluding the contract.”<sup>47</sup> This, of course, is however no barrier to ending the contractual relationship through mutual consent. Further, termination may also be sought on other grounds, such as, for instance,

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<sup>46</sup> Bernardini, *supra* note 24, at 420.

<sup>47</sup> Berger, *supra* nota 13, at 1369.

hardship, even lacking a specific contractual provision in that direction, whenever the applicable substantive law enables such an outcome.<sup>48</sup>

### *B. Arbitral Tribunal and Renegotiation Clauses*

Whenever a controversy arises between the parties, each may seek legal redress before a state court or, in the presence – as is very often the case – of an arbitration clause, before an arbitral tribunal.

Restricting our analysis to arbitration procedures, the first operation the arbitrator has to perform, is to verify whether the renegotiation clause may be deemed to have come into effect. In other words, the arbitrator shall first have to verify whether a triggering event has in fact occurred. In case such a condition were verified, the possible outcomes will, of course, depend on the content of the requests filed by each party. For instance, parties might have simply asked for the interpretation to be given to the renegotiation clause. However, besides merely interpretive conflicts, in all other cases in which renegotiation comes to a stall, independently of the question of good faith, parties might request the arbitral tribunal to supply an alternative regulation to the contractually established and – for that matter – still in force one. Generally speaking, the possible options the arbitrator will be faced with have been summarized by one commentator as follows:

- (i) the arbitrator may invite the parties to attempt to negotiate once again the terms of a revised agreement based on his findings;
- (ii) if such an attempt is unsuccessful, or in its absence, the arbitrator may determine that only the parties, and not the arbitrator, are entitled to proceed to the revision of the agreement, in which case the arbitrator may declare the latter as terminated, subject to awarding some kind of compensation to the aggrieved party should he find that the other party failed to act in good faith during the negotiations phase or on any other valid ground;
- (iii) the arbitrator may proceed to determine the manner in which the terms of the agreement should be revised in order to comply with the parties' objective of restoring the contractual equilibrium and issue an award effectuating such a revision.<sup>49</sup>

It is apparent from the above that the choice between the foregoing alternatives ultimately hinges on the question of the powers of, and conditions for, adaptation by the arbitral tribunal.

In this respect, it is useful to make a preliminary methodological clarification, with respect to the sources of law governing the various aspects of the arbitrator's activity: while the applicable procedural law should be understood as determining the powers of the tribunal, "the substantive law determines the *conditions* of contract adaptation."<sup>50</sup> More specifically,

[W]hether or not the conditions for an adaptation are met depends on the applicable substantive law. Whether or not the power of the arbitrator in this respect is curtailed, is a separate, procedural question. Any other solution would in a confusing manner combine two legal questions which should be treated separately, *i.e.* the

<sup>48</sup> See PETER, *supra* note 14, at 248

<sup>49</sup> Bernardini, *supra* note 24, at 420.

<sup>50</sup> JOACHIM FRICK, *ARBITRATION AND COMPLEX INTERNATIONAL CONTRACTS* 193 (2001).

question of applying the substantive law with the (procedural) question concerning the power of the arbitral tribunal. Arbitrators should not be treated different from national judges: If they are empowered to fill even contractual gaps relating to *essentialia negotii*, provided that the conditions of the substantive law for such gap filling have been met, arbitrators should be given the same power.<sup>51</sup>

This being said, there are three main questions which have to be answered, in order to determine what an arbitrator's course of action should be, when faced with the failure of renegotiation between the parties, and the demand for contract adaptation:

- a) does the applicable procedural law allow the arbitral tribunal to adapt the contract?
- b) are the conditions for contract adaptation set forth by the applicable substantive law met in the case at hand?
- c) if both the applicable procedural and substantive law allow such an intervention on the part of the arbitral tribunal, which criteria should the tribunal follow in adapting the contract?

Finally, a connected problem requiring separate attention is that of the enforceability of the ensuing arbitral award adapting the contract, pursuant to the New York Convention.

#### *1. Arbitrator's Powers According to Applicable Procedural Law*

One preliminary question which needs to be addressed, in order to provide guidance to arbitrators attempting to determine whether or not they are entitled the power to adapt the contract, is that relating to the determination of the applicable procedural law. First of all, it has to be clarified that the "*lex arbitri* is understood as the law that governs the validity of arbitration and arbitral award, and whose inherent parts [sic] is the control of the award by way of action for annulment."<sup>52</sup> As such, the *lex arbitri* is also that against which arbitrators should check whether they are entitled the power to adapt contracts.

This being said, the importance of a precise determination of the *lex arbitri* lays in that, in the context of arbitration of transnational contracts, it is likely that recognition and enforcement of the ensuing award will be sought in multiple countries. And, for such recognition and enforcement to be successfully obtained, it is further necessary that the conditions set forth in the New York Convention - that governs this matter - be fulfilled. In the words of a prominent commentator:

The principal provision concerning enforcement of awards is article V(1), which provides that a party to the Convention may refuse to recognize and enforce an arbitral award only if the party opposing enforcement can establish one of five procedural defenses:

1. there was not a valid arbitration agreement;
2. there was a lack of notice or denial of the opportunity to be heard;
3. the decision rendered was beyond the jurisdiction of the arbitral tribunal;

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<sup>51</sup> *Id.* at 194.

<sup>52</sup> Edin Karakas, *Origin of Arbitral Awards and its Impact on Applicable Enforcement Regime*, 11 CROATIAN ARBITRATION YEARBOOK [CROAT. ARBIT. YEARB.] 15, 16 (2004) (Croat.).

4. the composition of the tribunal, or the arbitral procedure, was contrary to the parties' agreement (or, failing agreement, to the law of the country where the arbitration took place); or
5. the award lacks binding effect, or has been set aside or suspended by competent authority in the country in which, or under the law of which, that award was made.

Article V(2) provides two additional defenses to recognition of an award which, unlike the defenses set out in article V(1), may be raised by the recognition and enforcement court itself: that the subject matter is not arbitrable or that enforcement would violate the forum's public policy.<sup>53</sup>

In particular, the condition set forth in number 5 in the quoted excerpt, corresponding to art. V.1(e), is the most relevant one, in that it provides respondents in proceedings for the recognition and enforcement of an award with a means to bring a "central attack" to its validity, by having it annulled in the country "in which or under the law of which" it has been made. This, in turn, could potentially foreclose its further recognition and enforcement in other countries.

In our view, however, reference to the annulment in the country "in which or under the law of which" the award has been made is not devoid of ambiguities. As a matter of fact, if art. V.1(e) is understood in terms of enabling the refusal of recognition and enforcement for the setting aside of the award in *either* of the two countries (*i.e.* that where the arbitral seat was located, and that whose procedural law governed the proceedings), this formulation might undermine the parties' choice of procedural law. In fact, upon consideration that – generally speaking – one of the grounds for setting aside arbitral awards according to national laws might also be the violation of procedural rules,<sup>54</sup> compliance with the law chosen by the parties to govern arbitral proceedings might not be enough to prevent annulment in the country of the arbitral seat. The award, in fact, may be found not to be in accordance with the *lex loci arbitri* – which, let us assume, was different from that chosen by the parties to govern arbitral proceedings – and hence annulled by a competent authority in the country of the arbitral seat. This, in turn, would enable courts of other countries to refuse recognition and enforcement of such an award. Such an outcome would, in our view, frustrate the parties' choice of procedural law by leaving them with an unenforceable award, notwithstanding even the strictest compliance with the law of their choice.

In light of this ambiguity, we wish to present some considerations on the criteria for determining the competence to set aside an award and, ultimately, for determining its foreign or domestic nature with respect to a given country. The purpose of this shall be to enable arbitrators to determine the applicable procedural law – against which they are to check their entitlement to the power of contract adaptation – so as to ensure transnational enforceability of the ensuing award.

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<sup>53</sup> W. Laurence Craig, *Some Trends and Developments in the Laws and Practice of International Commercial Arbitration*, 30 TEX. INT'L L.J. 1, 10-11 (1995).

<sup>54</sup> See UNCITRAL MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION, art. 34.2.(a).(iv) (1985) [hereinafter UNCITRAL Model law], available at [http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671_Ebook.pdf) (last visited Sept. 4, 2007) (“(2)An arbitral award may be set aside by the court specified . . . only if: a) the party making the application furnishes proof that: . . . iv) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties, unless such agreement was in conflict with a provision of this Law from which the parties cannot derogate, or, failing such agreement, was not in accordance with this Law . . .”).

a. The Role of Applicable Procedural Law in the New York Convention

As a matter of fact, the New York Convention applies to the recognition and enforcement of foreign awards. The definition of “foreign awards” adopted within this convention is two-pronged. On the one hand, by “foreign awards,” it is first of all meant “arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought.”<sup>55</sup> Secondly, foreign awards are also those “not considered as domestic awards in the State where their recognition and enforcement are sought”<sup>56</sup>

The counterpart to the first chunk of the definition of foreign awards (*i.e.* awards made in the territory of a different State, from that where recognition and enforcement are sought) within art. V.1(e) allows refusal of recognition and enforcement of the foreign award, if it has been annulled in the country *where it was made*. Similarly, the counterpart to the second chunk of the definition of foreign award (*i.e.* awards not considered as domestic in the country where recognition and enforcement are sought) within art. V.1(e) allows refusal of recognition and enforcement for annulment in the country *under the law of which* the award was made. Incidentally, it should be pointed out how the latter part of art. V.1(e), referring to countries “under the law of which” an award has been made, was actually added to conform to the extension of the convention’s scope – with respect to previous drafts of it – to awards “not considered as domestic” in the State where recognition and enforcement are sought.

In light of this, the meaning of “non-domestic awards” could then be extrapolated from this later *addendum* to art. V.1(e), to the effect that an award be considered as non-domestic only if rendered under the procedural law of some other country (with respect to that where recognition and enforcement are sought).

Against such an extrapolation, however, plays the fact that art. I.1 - referring to “awards not considered as domestic in the state where recognition and enforcement are sought” - could, and often is,<sup>57</sup> read so as to mean that there does not exist a definition of “non-domestic award” within the convention, but rather that any country may decide which definition to provide.

Yet, let us consider the unreasonable outcomes such a construction might lead to. Let us imagine two countries, Alpha and Omega. Alpha considers “non-domestic” those awards rendered in its territory under a different procedural law, while symmetrically allowing to arbitrate in another country under its arbitration law and treating the ensuing award as “domestic.” Omega, instead, considers “domestic” all awards rendered in its territory, regardless of the procedural law applied to them, and “non-domestic” those awards rendered abroad, albeit under its procedural law. Now, an award rendered in country Alpha under the law of country Omega would be considered “non-domestic” in either country, so that its annulment could neither be sought in Alpha nor in Omega. On the other hand, an award rendered in Omega under the law of Alpha would be considered “domestic” by both. In the latter case, if the award were upheld in Alpha but set aside in Omega, its recognition and enforcement could be refused in other States, despite the award’s compliance with the procedural law chosen by the parties.

This last case shows how the drafters’ intention to broaden the scope of mutual recognition and enforcement, through the introduction of the concept of “non-domestic awards,”<sup>58</sup> might be

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<sup>55</sup> New York Convention, *supra* note 4, art. I.1

<sup>56</sup> *Id.*

<sup>57</sup> See JAN VAN DEN BERG, THE NEW YORK ARBITRATION CONVENTION OF 1958, 24-25 (1994); Karakas, *supra* note 52, at 25.

<sup>58</sup> See VAN DEN BERG, *supra* note 57, at 24 (1994) (providing factual support to prove this intention).

practically frustrated when it is left up to individual states to provide the definition of “non-domestic.”

On the one hand, the Convention seems to envisage the possibility of electing a procedural law, different from that of the country where the arbitral seat is located. On the other hand, it leaves open the possibility that the ensuing award be judged and set aside in the country of rendition, making it unenforceable.<sup>59</sup>

However, before proposing an interpretation of the convention which would overcome this awkward situation, a further observation has to be made.

In fact, even if one were to recognize that non-domestic awards could only be those rendered in the country where recognition and enforcement are sought under a different procedural law, foreign awards under the convention should then be

- a) all those rendered abroad, regardless of the applicable procedural law, as well as
- b) those regarded as non-domestic with respect to the country where recognition and enforcement are sought.

The practical outcomes of such a construction can be readily exemplified. Let us imagine the case where Alpha allows recognition and enforcement of non-domestic awards - *i.e.* those rendered in its territory, under a different procedural law - as well as of all awards rendered abroad. Let us further assume that the same regime is enacted in Omega.

In this context, an award rendered in Omega under the law of Alpha would be regarded as non-domestic by both states, and hence not subject to the jurisdiction of either for the purpose of annulment. Therefore, such an award might only be challenged in each forum where recognition and enforcement are sought, lacking the possibility to carry a “central attack” against it, pursuant to art. V.1(e). However, “[w]hile examination of an award in conjunction with its recognition or enforcement may eliminate harmful consequences of the irregular award in an individual case, it does not provide means for the full elimination of the disputed arbitral decision, for the decision (not) to recognise and enforce an award in one country does not entail any consequences for recognition and enforcement of the same award in another country.”<sup>60</sup> This solution ends up unduly disfavoring respondents in proceedings for the recognition and enforcement of arbitral awards, in that it narrows down the legal remedies available to them against due process violations.<sup>61</sup>

We submit that the latter outcome was not the one envisaged by the convention drafters, in that reference to the country where the award was made (as a criterion to ground competence for annulment) was likely introduced under the assumption that “an award is governed by the arbitration law of the country where the award is made.”<sup>62</sup> An assumption which, while relying

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<sup>59</sup> At least in countries different from that whose procedural law was made applicable to the proceedings.

<sup>60</sup> Lojze Ude, *Setting Aside Arbitral Awards*, 1 CROAT. ARB. YEARB. 77, 78 (1994).

<sup>61</sup> In fact, given that (a) compliance with procedural rules is to be understood as a means to provide parties with the fullest opportunity to *concur* to the identification of the relevant facts and application of rules of law for the purpose of deciding their case (in other words, to be heard), and (b) defining due process as the right to a fair and effective “hearing with respect to legal as well as factual disputes,” (Amy Coney Barrett, *Stare Decisis and Due Process*, 74 U.COLO. L. REV. 1011, 1013 (2003)) forcing respondents to challenge the award on grounds of due process violations in each *forum* where its recognition is sought eventually weakens their right to a legal remedy against such violations.

<sup>62</sup> VAN DEN BERG, *supra* note 57, at 23.

excessively<sup>63</sup> on the arbitral *situs* as an indicator for choice-of-law purposes, however brings to light the connection between arbitral seat and applicable procedural law which the drafters had in mind. Hence, the link should be one based on the procedural law applied to the proceedings, rather than on mere geographic location of the *situs*.

A more reasonable interpretation of art. V.1(e) might then require to enable the setting aside in the *loci arbitri*, under the implicit condition that the award also be governed by the *lex loci arbitri*. As a consequence, the possibility of annulment in the country *where the award was made* would then be absorbed in the possibility of annulment in the country *under the law of which* the award was made. Such country could in fact be that of the arbitral seat, only provided that the award also be governed by the *lex loci arbitri*.

The eventual adoption of a single criterion, that of the procedural nationality, for determining competence to set aside an award, would then provide a solution to the previous example. In fact, the award having been rendered in Omega under the law of Alpha, it should then be open for annulment only in the country *by the law of which* it was governed, *i.e.* Alpha.

#### b. Interpretation of New York Convention After Procedural Nationality

In sum, if it were left to individual contracting states to define the notion of “non domestic award,” they could for instance all choose to extend their jurisdiction upon awards rendered in their territory under a different procedural law. This, however, would restrict party autonomy with respect to the choice of procedural law to the choice of *situs*, contrary to the convention’s orientation on enabling parties to separately choose the arbitral *situs* and the *lex arbitri*.<sup>64</sup>

Alternatively, while some countries might decide to exert jurisdiction upon all awards rendered within their boundaries, others might limit themselves to the setting aside of awards rendered within their boundaries *and* under their procedural law. In this case, decisions rendered in a country belonging to the latter group under the law of a country of the former could be regarded as foreign by both, with the effect that no forum for having them set aside would be available to the respondent in proceedings for recognition and enforcement of the award.

Moreover, in case some states considered domestic those awards rendered anywhere under their procedural law, while others adopted the exclusive criterion of the location of the arbitral seat, an award rendered in a country belonging to the latter group under the law of a country belonging to the former could instead be set aside in both, with the risk of being invalidated for non-compliance with the *lex loci arbitri*, despite the parties’ intention to have their dispute governed by another law.

Finally, were countries not enabled to choose their own definition of “non-domestic awards,” having to adopt that implicit in the convention (*i.e.* awards rendered in the country where recognition and enforcement are sought under a law, different from the *lex loci arbitri*), while simultaneously having to consider as “foreign” all awards rendered abroad, regardless of the

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<sup>63</sup> As a matter of fact, “if the law of the arbitral *situs* was not a reason for which the parties chose the *situs*, then the application of the law of the *situs* must be justified on grounds other than the parties’ choice of law.” (Hans Smit, *A-national Arbitration*, 63 TUL. L.REV. 629, 637 (1989)) In so doing, arbitrators should give due weight to the considerations that favor applying a particular national law, *i.e.* those specific “foreign” elements of the submitted dispute, which may however vie for the application, besides the *lex loci arbitri*, “of the law chosen by the parties, the law of any of the parties, the law of the place of conclusion or performance of the contract, and the law of the place where the award is likely to be enforced.” (Smit, 635)

<sup>64</sup> *Id.* at 641 (“The New York Convention, by referring explicitly to the law under which the award was made, stresses that the law of the arbitral *situs* is not necessarily applicable in determining whether an award should be recognized and enforced.”)

applicable procedural law, there might once again be no forum available to the respondent for having the award set aside, if it were rendered in one country under the procedural law of another.

This, in our view, is not entirely consistent with the Convention's purpose to ensure as broad as possible a recognition to "foreign" arbitral awards,<sup>65</sup> under the implicit condition that all other circumstances and guarantees (first and foremost the possibility to have the award set aside, once and for all, in a single country) remain equal.

In this respect, Article 31(1) of the Vienna Convention on the Law of Treaties mandates that a treaty has to be interpreted, *inter alia*, "in light of its object and purpose."<sup>66</sup> In light of this, we feel only one criterion should be adopted for the purpose of determining when an award is foreign and therefore entitled to recognition (but also open to annulment in the – single - country with respect to which it should be regarded as domestic); such criterion being that of the procedural nationality of the award. To this end, several interpretive steps have to be taken.

First of all, by understanding the expression "awards *not considered* as domestic awards *in* the State in which recognition and enforcement are sought"<sup>67</sup> in terms of "awards *not qualifying as* domestic awards *with respect to* the State in which recognition and enforcement are sought," the applicability of the convention could be made to hinge not on whether "a particular state considers an award as non-domestic, but on whether the Convention considers it as non-domestic and entitled to recognition."<sup>68</sup>

The following step would then be that of searching for a definition of "non-domestic award" within the text of the Convention. This could further be achieved by construing Article V.1(e) (establishing that an award may be refused recognition if set aside in the country in which *or* under the law of which it has been rendered) so as to exactly parallel the two-pronged definition of "foreign awards" adopted by art. I.1, in order to establish a biunivocal correspondence between "non-domestic awards" and "awards rendered under the law of a country different from that where recognition is sought." The means to this end would be that of construing the annulment of an award in the country *under the law of which* it has been rendered, as a substitute, rather than supplementary, ground for refusal of recognition. In other words, Article V.1(e) should be taken to imply that if parties opted for a *lex arbitri* different from that of the *situs*, only the country whose law is chosen should be competent to set aside the award.<sup>69</sup> From

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<sup>65</sup> See Jan Paulsson, *Awards Set Aside at the Place of Arbitration*, in UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, ENFORCING ARBITRAL AWARDS UNDER THE NEW YORK CONVENTION: EXPERIENCE AND PROSPECTS 23 (1998), available at <http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/NYCDay-e.pdf> (last visited Sept. 4, 2007) ("Broadly speaking, the New York Convention was intended to make it easier to enforce an arbitral award rendered in one country in the courts of other countries.").

<sup>66</sup> Vienna Convention on the Law of Treaties art. 31.1, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention].

<sup>67</sup> New York Convention, *supra* note 4, art. I.1 (emphasis added).

<sup>68</sup> Hans Smit, *supra* note 63, at 643. After all, had the drafters really wanted to leave to Contracting States the definition of "non-domestic" awards, they could have easily written down "awards not considered as domestic awards *by* the State in which recognition and enforcement is sought," whereas the expression "not considered as domestic . . . *in* the State" (New York Convention, *supra* note 4, art. I.1 (emphasis added)) is ambiguous, in that it might either take the meaning of *by* if "in the State" is read in connection with "considered" ("considered . . . *in* the State") or of *with respect to*, if understood as a clause, accessory to "domestic" ("not considered as [']domestic['] . . . [-] *in* the State").

<sup>69</sup> See also Pieter Sanders, *New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, 6 NETHERLANDS INTERNATIONAL LAW REVIEW [NETH. INT'L. L. REV.] 43, 56 (1959) (Neth.) ("Here only one competent authority is meant; either the Court of the country where the award was made, or the Court of the country under the law of which the award was made."); Lojze Ude, *supra* note 60, at 81 (1994) ("In the

this would then follow that “non-domestic awards” could rightly be identified as those rendered in the country where recognition is sought under the procedural law of another state.

However, the foregoing construction of the grounds for refusal of recognition contained in art. V.1(e) would allow to go even further. As a matter of fact, it implies the condition that the award be governed by the *lex loci arbitri*, as a prerequisite for annulment in the country of the arbitral seat. However, this interpretation would ultimately mean that the only relevant criterion for determining the competence to set aside an award and, hence, its domestic or foreign nature, would be that of procedural nationality. Therefore, it would also eliminate the undue deprivation of the possibility of “central attack” against awards for due process violations, which arises when the criterion based on procedural nationality is used *in conjunction* with that of the location of the arbitral seat.

Foreign awards would then be those rendered in a country different from that where recognition and enforcement are sought - under a procedural law different from that of the forum of recognition - as well as those rendered in such country – under foreign procedural law.

Such view could also be supported by the decision in *Bergesen v. Joseph Muller Corp.*,<sup>70</sup> which qualifies as “subsequent practice in the application of the Treaty”, for the purposes of Article 31.3(b) of the Vienna Convention. In said decision, the U.S. District court stated that “awards ‘not considered domestic’ denotes awards . . . made within the legal framework of another country . . . .”<sup>71</sup> Albeit failing to expressly refer to the procedural criterion as the mechanism to determine an award’s nationality, its relevance lays in that it attempts to trace a correspondence between an award’s non-domestic character, and its connection to a foreign legal framework; connection which we deem should instead be sought with respect to the applicable procedural law.

### c. Criteria for Choosing the Applicable Procedural Law

If the above is correct, there are several conclusions, which can be drawn with respect to the problem of our interest, that is the choice of applicable procedural law. First of all, the road would be open for the recognition of complete party autonomy in the choice of the law governing arbitral procedure. In other words, “parties and arbitrators might choose to apply to the arbitral procedure a law other than the law prevailing at the place of arbitration.”<sup>72</sup>

Allegiance would no longer be due to the *lex loci arbitri* for transnational recognition purposes. In fact, given the choice of a procedural law, all the grounds for refusal of recognition set out in art. V.1 should be referred to the latter. Furthermore, also the competence for annulment of the award would be vested solely in the country whose procedural law was chosen to govern the proceedings.

If the relevant criterion for granting recognition and enforcement to an award is identified solely in its procedural nationality, it follows that “[t]he proper rule to apply to all arbitral awards

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determination of the country whose law plays the decisive role in the use of legal remedies to set aside an award and whose authorities are competent to make the decision on the nullification of the award, the primary criterion is the autonomy of the will of the parties. The jurisdiction of the country in which the award was issued is given only in the case that no other agreement between the parties exists.”) (citing Mihajlo Dika, *Pobijanje arbitraznih odluka [Setting Aside Arbitral Awards]*, in *ARBITRAZNO RJESAVANJE MEDUNARODNIH TRGOVACKIH SPOROVA [ARBITRAL RESOLUTION OF COMMERCIAL DISPUTES]* 45 (Krešimir Sajko & Mihajlo Dika eds. 1988)(Croat.))

<sup>70</sup> 710 F.2d 928 (2d Cir. 1983).

<sup>71</sup> *Id.* at 932

<sup>72</sup> Filip De Ly, *The Place of Arbitration in the Conflict of Laws of International Commercial Arbitration: An Exercise in Arbitration Planning*, 12 NW. J. INT’L L. & BUS. 48, 69 (1991).

is that an award shall be recognized and enforced if it is valid under applicable law,<sup>73</sup> a rule which may then require “recourse to foreign law under proper choice of law principles”<sup>74</sup> leading to the realization that “[a]pplication of the proper choice of law rule ultimately depends on the tribunal in which its application is sought.”<sup>75</sup>

In light of this, lacking any party choice, arbitrators faced with the problem of determining the procedural law to be applied<sup>76</sup> should resort to the same method, often used in determining the applicable substantive law under the same circumstances, which one commentator described as follows: “[I]nternational commercial arbitrators decide disputes by applying a national law which, in most cases, is established by the national private international law or of a conflict-of-laws methodology compatible with the solutions afforded by the national legal orders concerned by the dispute.”<sup>77</sup>

In fact, if an award’s transnational recognition and enforceability ultimately depends on its procedural nationality, lacking any party choice to this end, arbitrators should follow a methodology that could allow them to reach a determination, consistent with that which would be reached by national judges - pursuant to the conflict of laws provisions in force in their respective *fora* - whom recognition and enforcement of the arbitral award could likely be requested to. To this end, it would then be important for them to take account of the solutions suggested by the choice of law provisions of those legal systems which the controversy displays a connection with.<sup>78</sup>

As for the possibility that parties or arbitrators settled on *institutional*, i.e. non-national rules, such as those of the International Chamber of Commerce, it has been observed how, pursuant to Art. V.1(e) of the New York Convention, enforcement of an award could be refused if the respondent established that the award has been set aside by a court of the country in which, or

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<sup>73</sup> Smit, *supra* note 63, at 639

<sup>74</sup> *Id.* at 640.

<sup>75</sup> *Id.* at 635.

<sup>76</sup> This possibility has also been recognized by some national laws. For examples of provisions enabling the arbitral choice of a procedural law lacking party determinations to this end, see Loi fédérale sur le droit international privé [LDIP][Federal Private International Law Act], Dec. 18, 1987, Recueil systematique du droit fédéral [RS] 291, art. 182 (Switz); Codice di procedura civile [C.P.C.][Code of Civil Procedure], art. 816 (Italy); Nouveau code de procédure civile [N.C.P.C.][New Code of Civil Procedure] art. 1494 (Fr.). At any rate, it is submitted that such legislative openings would have a specific meaning, if the view were adopted that, in default of party choice of procedural law, the law of the seat would apply; a view which, as is explained in the sequel, the authors do not share.

<sup>77</sup> HORACIO A. GRIGERA NAON, CHOICE-OF-LAW PROBLEMS IN INTERNATIONAL COMMERCIAL ARBITRATION 59 (1992). Similarly, also with reference to applicable substantive law, see PETER, *supra* note 14, at 136 (“A . . . technique used by arbitrators is the cumulative application of the different rules of conflict of the countries having a connection with the case. Using a comparative method, the arbitrator applies the substantive rule which would be applied by reference to the different potentially applicable substantive laws designated by the different conflict of laws rules.”)

<sup>78</sup> As a matter of fact, such a rationale could also justify the exercise of checks and controls on the part of arbitrators even with respect to the parties’ express choice of procedural law, in order to account for the possibility that the choice of law provisions of a certain connected state did not recognize the parties’ choice as the primary criterion for finding the applicable procedural law. However, there exists an international consensus on giving primacy to the will of the parties, which is embodied in important conventions, such as the New York Convention or the European Convention on International Commercial Arbitration (April 21, 1961, 484 U.N.T.S. 364). Such consensus warrants the conclusions that “[i]n practice the difference with the conflict rules applied in most countries may not be great . . . .” (Peter Nygh, *Choice of Forum and Laws in International Commercial Arbitration*, 24 FORUM INTERNATIONALE 1, 7 (1997)).

under the law of which, that award had been made. We feel this argument to be sufficient indication that the award must have been made under the law of some national system.<sup>79</sup>

As a consequence, when applying *institutional* procedural rules, such as those of the International Chamber of Commerce, arbitrators should keep in mind the requirement implicit in the New York Convention that the award be governed by some national procedural law. Hence, considering that rendering an unenforceable award is never a good practice, arbitrators should nonetheless take account of national procedural rules which may be deemed applicable by national judges of the *fora* where enforcement of the award could be sought.<sup>80</sup>

#### d. The Notion of Dispute

Once having understood how the applicable procedural law should be determined, it has to be considered whether such law vests arbitrators with the power to issue a decision on the question of contract adaptation *vis-à-vis* the failure of renegotiation procedures. More specifically, this issue revolves around the possibility to qualify the failure of the parties to reach an agreement under a renegotiation clause as a "dispute," given that many procedural laws abide by the principle that "[w]ithout a 'dispute,' the arbitral tribunal may not exercise jurisdiction . . . ."<sup>81</sup> If this much is achieved, then the power of the arbitral tribunal to adapt the contract for the parties would automatically follow.

In light of this, it has to be considered how the traditional understanding of "dispute," to the purpose of grounding arbitral jurisdiction, is usually that of a conflict revolving around the existence or scope of specific rights and obligations of the parties, whereas the failure of renegotiations rather falls in the category of mere conflicts of (economic) interests.

Bodies of procedural rules requiring the existence of a dispute are those of the International Chamber of Commerce,<sup>82</sup> the Convention on the Settlement of Investment Disputes between States and Nationals of Other States<sup>83</sup> as well as the UNCITRAL Model Law<sup>84</sup> (whose provisions have been adopted by a number of national jurisdictions).

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<sup>79</sup> For this conclusions, see VAN DEN BERG, *supra* note 57, at 37. Excluding the possibility of an anational aritation, see Smit, *supra* note 63, at 631 as well as William W. Park, *The Lex Loci Arbitri and International Commercial Arbitration*, 32 INT'L & COMP. L.Q. 21, 26 (1983).

<sup>80</sup> After all, the very ICC Rules of Arbitration, at art. 15, para.1, enable arbitrators to resort the rules of procedure of a national law (albeit only in case of regulatory loopholes in the ICC Rules).

<sup>81</sup> John Y. Gotanda, *Renegotiation and Adaptation Clauses in Investment Contracts, Revisited*, 36 VAND. J. TRANSNAT'L. L. 1461, 1465 (2003).

<sup>82</sup> ICC Rules of Arbitration, *supra* note 34, art. 4.3(b) (" A party wishing to have recourse to arbitration under these Rules shall submit its Request for Arbitration.... The Request shall, *inter alia*, contain the following information: ...b) a description of the nature and circumstances of the dispute giving rise to the claim(s).")

<sup>83</sup> Mar. 18, 1965, 575 U.N.T.S. 159 [hereinafter ICSID Convention]. "Article 25(1) requires that the dispute must be a 'legal dispute arising directly out of an investment.' The expression 'legal dispute' has been used to make clear that while conflicts of rights are within the jurisdiction of the Centre, mere conflicts of interests are not. The dispute must concern the existence or scope of a legal right or obligation, or the nature or extent of the reparation to be made for breach of a legal obligation." (*Report of the Executive Directors on the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States*, in INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES, ICSID CONVENTION, REGULATIONS AND RULES 44 (2006), available at <http://www.worldbank.org/icsid/basicdoc/basicdoc.htm> (last visited Sept. 6, 2007)).

<sup>84</sup> UNCITRAL Model Law, *supra* note 54, art. 7(1). ("'Arbitration agreement' is an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not.")

Hence, were one to endorse such a restrictive notion of “conflict” for the purpose of grounding arbitral jurisdiction, arbitrators would definitely not be entitled to the power of issuing a decision that could “re-make” the contract in default of party agreement.

This being said, it has however to be pointed out how, with specific reference to long-term contracts, a less restrictive interpretive tendency has slowly replaced the traditional “dispute-oriented” notion of arbitration, and also found its way into some national laws on arbitration.<sup>85</sup>

The aforementioned tendency may be summarized as follows:

It may be assumed that in the case the parties to a contract, acting in virtue of contractual provisions, cannot come to an agreement as to the adaptation of the contract to substantially changed circumstances or as to the filling the “gap” in it, there exists between them a dispute on this matter. If the parties have agreed between themselves that disputes of such kind are subject to decision by means of arbitration, the competence of the arbitral tribunal to give a decision in the form of award on the disputed subject matter cannot be questioned. Such award should be treated as any other final award, and, while having a constitutive character, should be subject only to such control by ordinary courts as is provided for any other arbitral award.<sup>86</sup>

Let us assume that, under the aforementioned perspective, failure of renegotiations were a sufficient basis for submitting the question of contract adaptation to an arbitral tribunal, and that the ensuing award would therefore retain jurisdictional nature.<sup>87</sup> Then, a further legal question would arise, relating to the extent to which an “ordinary” expression of will - embodied in a general arbitration clause - could be deemed to also cover arbitral adaptation of contracts. The importance of such a question lays in that the arbitral tribunal may not exceed the powers conferred upon it by the parties. In other words, the procedural feasibility of contract adaptation also has to be matched by the parties’ will, embodied in the arbitration agreement, to submit such type of conflicts to arbitrators.

In this respect, some commentators, probably under the influence of some national laws, such as the Dutch one,<sup>88</sup> differentiate contract adaptation from the solution of other disputes, and require parties to expressly confer this power to adapt the contract to the arbitral tribunal.<sup>89</sup> After all, it could be argued - in further support of such position - that whereas the resolution of conflicts relating to the parties’ rights and obligations arising from a contract is a question on an

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<sup>85</sup> See Arbitration Act, 1996, c. 23, §82(1) (U.K.) (qualifying as a “dispute” any conflict whatsoever between the partes). For reference to other national laws, such as the Dutch and Swedish ones, see Berger, *supra* nota 13, at 1373 n. 108 & 110, 1376.

<sup>86</sup> Tadeusz Szurski, *Arbitration Agreement and Competence of the Arbitral Tribunal*, in INTERNATIONAL COUNCIL FOR COMMERCIAL ARBITRATION, UNCITRAL'S PROJECT FOR A MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION 53, 67 (1984).

<sup>87</sup> For further discussion and support of such position, see Berger, *supra* note 13, at 1375 ff. (“A multitude of modern developments supports the assumption of a more extensive jurisdiction for arbitral tribunals, including the authorization to adjust and adapt contracts.”)

<sup>88</sup> Wetboek van Burgerlijke Rechtsvordering [RV][Code of Civil Procedure], art. 1020 (4) (Neth.) ( “By agreement . . . may also be subject to arbitration . . . the supplementation or alteration of legal relations.”).

<sup>89</sup> See Berger, *supra* note 13, at 1379. (“[T]hird party adjustment . . . requires that the parties make clear that they wish to transfer to the tribunal this ‘creative competence’ which goes beyond normal dispute adjudication . . . The presence of a normal arbitration agreement in the contract will not suffice to this purpose. Instead, an express allocation to the arbitral tribunal of the competence to adapt the contract is required.”)

“existent state of the world,” contract adaptation in default of party agreement rather borders in the “hypothetical” and the “possible.” Hence, the more aleatory nature entailed by arbitral adaptation could rightly justify a stronger expression of will, additional to the general arbitration agreement.

The latter position is instead rejected by others, upon consideration that, once the meaning of “dispute” is understood in terms of “whatever conflict the parties may want to submit to the arbitral tribunal,” therefore including conflicts of interests and differences of opinion, the simple drafting of a general arbitration clause should be able to cover contract adaptation cases as well.<sup>90</sup>

The same conclusion has been attained by the arbitral tribunal in ICC Award n. 5754/1988, deducing the parties’ will to confer upon it the power to adapt the contract, by the very nature of the contract in which the arbitration clause was included:

The clause must always be interpreted as part of, and in the light of, the particular contract in which it appears. Here it is used in a long term contract, with a number of provisions which may require adjustment over the period of that contract. If the conclusion is that the parties contemplated arbitration with a view to their adjustment, as it certainly is (“all disputes arising in connection with this contract”), then this clause should be interpreted even though in other contexts it might be given a narrow scope.<sup>91</sup>

## 2. *Applicability of the New York Convention to Awards Adapting Contracts*

The question of whether arbitral jurisdiction may be grounded - according to the applicable procedural law - even upon the submission of a request for contract adaptation *vis-à-vis* the failure of renegotiation is, as observed in the preceding paragraph, relevant for the arbitral tribunal to determine whether it may issue a valid pronouncement upon such a request. The answer to such question is, however, all the more important when one considers that “if the tribunal exercises jurisdiction improperly, any decision adapting the contract may be unenforceable under the New York Convention.”<sup>92</sup>

In fact, for the purposes of transnational recognition and enforcement pursuant to the New York Convention (which, as already said, applies to foreign arbitral awards), it is not only necessary to determine an award’s domestic or foreign nature with respect to a given country, as has been done in Part B.1.a, but also to determine whether a certain third-party pronouncement qualifies as an award.

However, failing a definition of what must be understood by an arbitral award under the New York Convention, this notion should be distilled “from what is generally understood by arbitration in the national legal systems,”<sup>93</sup> that is by carrying out a comparative analysis of the laws on arbitration.

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<sup>90</sup> See FRICK, *supra* note 50, at 196 (“Some laws . . . expressly require the parties to . . . give arbitrators the authority and competence to render their decision on adaptation in the form of a genuine arbitral award. In our opinion, such express clause is not necessary. The arbitrators [sic] judicial power to decide all legal questions includes the power to fill gaps resulting from a change in the circumstances and to adapt contracts.”)

<sup>91</sup> ICC Award No. 5754 (1988), *cited in* W. LAURENCE CRAIG, WILLIAM W. PARK & JAN PAULSSON, INTERNATIONAL CHAMBER OF COMMERCE ARBITRATION, 112 (2nd ed. 1990).

<sup>92</sup> Gotanda, *supra* note 81, at 1466.

<sup>93</sup> VAN DEN BERG, *supra* nota 57, at 44

“Arbitration” could then be defined in terms of a dispute settlement procedure - governed by a State’s Law on Arbitration<sup>94</sup> - between parties, by a third person deriving his power from an agreement of the parties and whose decision is binding upon them.<sup>95</sup> Consequently,

[P]rocedures akin to arbitration not governed by the Law on Arbitration fall outside this notion. Accordingly, those decisions which are not considered as the result of arbitration proper in country of origin must be deemed not to come within the purview of the New York Convention and cannot be enforced as a foreign arbitral award under it.<sup>96</sup>

In this respect, the determination of whether failure to agree in the context of contractual renegotiation - amounting to a “dispute” - grounds arbitral jurisdiction according to the applicable procedural law, is a necessary prerequisite for treating the ensuing third-party decision adapting the contract as an arbitral award, for the purposes of the New York Convention.

In other words, the recognition of arbitral authority over conflicts arising from failed renegotiation procedures acquires a twofold meaning. On the one hand, it means that the arbitral tribunal is entitled to the power of contract adaptation. Secondly, it signifies that such a decision, issued in the context of properly-grounded (according to applicable procedural law) arbitral *jurisdiction*, will qualify for recognition and enforcement in other legal systems as well.

In light of these further considerations, we submit that, although it is true that arbitration is generally conceived as a substitute for court litigation, so that, theoretically, “the matter submitted to the arbitrator must concern a judicially triable issue”<sup>97</sup> - meaning an issue suited to adjudication “in the sense of a clear ‘yes or no’ decision”<sup>98</sup> – there are several reasons for adopting a less restrictive attitude in interpreting the requirements set forth by national laws for grounding arbitral jurisdiction. In particular, such an attitude should receive serious consideration at the very least with respect to long-term contracts, where renegotiation and contract adaptation are “part of the game.”

First of all, there are a number of countries in which the matter of adaptation of contracts or filling of “gaps” is considered to be arbitrable or, at least, it is current practice to do so. Secondly,

Even if a state court be treated as not being called upon to create agreements for and instead of the parties, such position should not by itself prejudice the lack of competence of the arbitral tribunal to adapt a contract or to fill its gaps in the case the parties so request. There is a substantial difference between the legal ground of the competence of an ordinary court and the competence of the arbitral tribunal, the former performing its judicial functions on a statutory basis, while the latter exclusively on the basis of the agreements of the parties and their mandate. Hence, even in the case the statutory law of a country does not foresee the competence of the

<sup>94</sup> “[C]ontained either in the provisions of the Code of Civil Procedure or in a separate Arbitration Act.” (*Id.*)

<sup>95</sup> See PETER, *supra* note 14, at 252

<sup>96</sup> VAN DEN BERG, *supra* nota 57, at 46. Where by “country of origin” it is meant that “in which, or under the law of which, that award was made.” (*Id.* at 19).

<sup>97</sup> *Id.* at 44.

<sup>98</sup> Berger, *supra* note 13, at 1373.

ordinary court to adapt a contract or to fill gaps in it, on the request of the parties, this should not automatically exclude the possibility to perform such function by the arbitral tribunal acting within the framework of the will of the parties expressed in the arbitration agreement.<sup>99</sup>

After all, a request of contract adaptation before an arbitral tribunal would still differ from the decision of an arbitral-expert - in the form of a “contractual arbitration” (meaning having the mere force of a contract, rather than of a jurisdictional pronouncement) - between the parties. In fact, “the process of adapting or supplementing a contract by the arbitral tribunal would be subject to the same procedural safeguards as the process of settling ‘legal’ disputes,”<sup>100</sup> which provides *per se* a sound justification of the parties’ will to specifically settle their disputes by arbitration, rather than by other forms of third-party intervention.

At any rate, keeping in mind the foregoing general interpretive guidelines, the question of the arbitrability of the matter of contract adaptation should nonetheless be dealt with on a case-by-case basis, extrapolating the legal rule within a given legal system through a comparative analysis of its constituent elements, its “legal formants.”<sup>101</sup>

### C. Substantive-law conditions for contract adaptation

If it were ascertained that arbitral jurisdiction could be validly grounded even upon the request of contract adaptation *vis-à-vis* failed renegotiation procedures, it should still be inquired whether the conditions - set forth by the applicable substantive law – occur, for judicial and – therefore – arbitral adaptation to take place.<sup>102</sup> The following sections attempt to provide a brief outline of the conditions for judicial contract adaptation, set forth by the substantive laws of the United States, France, Germany, Switzerland and Italy.

#### 1. United States

The greatest openings to judicial adaptation of contracts have occurred in the so-called *Westinghouse*<sup>103</sup> and *ALCOA v. Essex*<sup>104</sup> cases.

In the former case, the court’s role was however limited to the appointment of a special observer, so as to allow parties to settle the matter through out of court negotiations.<sup>105</sup> In *ALCOA v. Essex*, instead, the court went further, adapting *tout court* the pricing system of a long-term contract.

In particular, the case dealt with performance of an agreement under which Essex would supply ALCOA with alumina, which ALCOA would then convert by a smelting process into

<sup>99</sup> Szurski, *supra* note 86, at 67.

<sup>100</sup> *Id.* at 66.

<sup>101</sup> “[A] list, even an exhaustive one, of all the reasons given for the decisions made by the courts is not the entire law. Neither are the statutes the entire law, nor are the definitions of legal doctrines given by scholars. In order to know what the law is . . . it is necessary to analyze the entire complex relationship among . . . the ‘legal formants’ of a system, i.e., all those formative elements that make any given rule of law amidst statutes, general propositions, particular definitions, reasons, holdings . . . .” (Mauro Bussani & Ugo Mattei, *The Common Core Approach to European Private Law*, 3 COLUM. J. EUR. L. 339, 344 (1998))

<sup>102</sup> See FRICK, *supra* nota 50, at 193.

<sup>103</sup> *In re Westinghouse Elec. Corp. Uranium Contracts Litigation*, 517 F. Supp. 440 (E.D.Va. 1981).

<sup>104</sup> *ALCOA v. Essex*, *supra* note 17.

<sup>105</sup> The case dealt with Westinghouse Electric Corporation’s refusal to perform uranium supply contracts because of sharply rising prices.

molten aluminum. In light of the effects of inflation on the cost of producing aluminum (which rose unforeseeably beyond the indexed increase enabled by an automatic adaptation clause included in the contract), ALCOA, the plaintiff, later asked for an equitable reformation of the contract price.

In this context, the District Court first found that the doctrines of *mutual mistake*, *frustration of purpose* and *impracticability*<sup>106</sup> applied to the case at hand. These doctrines, however, generally allow only relief from performance. In light of this, the court first observed that “[t]o frame an equitable remedy where frustration, impracticability or mistake prevent strict enforcement of a long term executory contract requires a careful examination of the circumstances of the contract, the purposes of the parties, and the circumstances which upset the contract.”<sup>107</sup> And it later concluded that “[a] remedy modifying the price term of the contract in light of the circumstances which upset the price formula will better preserve the purposes and expectations of the parties than any other remedy.”<sup>108</sup>

Finally, the Court suggested four factors that, in its opinion, would

[P]rove to be of durable importance in deciding whether to modify contracts: (1) the parties' prevision of the problems which eventually upset the balance of the agreements and their allocation of the associated risks; (2) the parties' attempts at risk limitation; (3) the existence of severe out of pocket losses and (4) the customs and expectations of the particular business community.<sup>109</sup>

## 2. France

French law is, in principle, one of the most reluctant to recognize the possibility of judicial adaptation of contracts, as stands out from this statement by the Cour de Cassation (highest court of ordinary jurisdiction): "in no case do the courts have the right, however equitable may appear to be their decision, to take into account the time and the circumstances, to modify existing contracts and substitute new provisions for those which have been freely accepted by the contracting parties."<sup>110</sup>

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<sup>106</sup> “The doctrines of frustration and impracticability both deal with the effect of supervening events on contract performance. They are complemented by the doctrine of mistake, which deals with the effect of mistake as to existing fact at the time of contracting.” (PETER, *supra* note 14, at 251). Incidentally, it should be noted how failure of the indexing formula to account for supervening economic factors was deemed a mistake of fact, after the following reasoning:

[T]he practical necessities of the very long term service contract demanded an agreed risk limiting device. Both parties understood this and adopted one. The capacity of their selected device to achieve the known purposes of the parties was not simply a matter of acknowledged uncertainty . . . .It was more in the nature of an actuarial prediction of the outside limits of variation in the relation between two variable figures . . . .Is capacity to work as the parties expected it to work was a matter of fact, existing at the time they made the contract.

This crucial fact was not known, and was scarcely knowable when the contract was made. But this does not alter its status as an existing fact. The law of mistake has not distinguished between facts which are unknown but presently knowable... and facts which presently exist but are unknowable. Relief has been granted for mistakes of both kinds. (ALCOA v. Essex, *supra* note 17, at 64).

<sup>107</sup> ALCOA v. Essex, *supra* note 17, at 79

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 92

<sup>110</sup> Cass.civ., Mar. 6, 1874, D.P. I, 179 (1876), *cited in* FRICK, *supra* note 50, at 213.

The greatest exception to this principle of sanctity of contract is the doctrine of *imprévision* (*i.e.* unforeseeability), originally adopted with respect to contracts subject to administrative law.

As one commentator put it:

If, for example, the motorway building company cannot obtain the expected compensation for its investment because of a lack of toll paying traffic after construction, then the *Conseil d'Etat* [highest administrative court] can remedy this situation inviting the parties to renegotiate the contractual *terms in the interest of the public service*.<sup>111</sup>

Such doctrine, in particular, applies as a means to offset the contractor's obligation to continue providing a public service, and enables judicial contract adaptation upon the occurrence of an unforeseen change in circumstances.<sup>112</sup>

Beyond this situation, only in very rare cases have French courts enabled contract adaptation, and only in presence of external, unforeseeable events beyond the parties' control.

In this respect, one interesting case is *E.d.F. v. Shell Française*,<sup>113</sup> dealing with a supply contract of fuel oil, whose price had to be determined in accordance with an indexation clause based on a superior and an inferior price limit. The indexing clause was in turn supplemented by a renegotiation provision, establishing that, beyond a certain increase in price, parties would meet to study possible modifications to be made in the contract pricing system.

Following the Kippur war and the ensuing oil price increase, the effects on the contractual pricing system were such as to render it a no longer viable risk-limiting device.

Upon failure of negotiations conducted pursuant to the renegotiation clause, the parties submitted the matter to the court of first instance (Tribunal de Commerce), and while Shell (the supplier) requested contract termination for the price being no longer fixed, E.d.F., on the other hand, sought contract adaptation. The court of first instance first affirmed that the indication of a new indexation mechanism would have been possible only to the extent that such operation amounted to mere *replacement*, and not to actual *adaptation*.<sup>114</sup> Consequently, it decided to terminate the contract, holding that doing otherwise - *i.e.* modifying the indexation clause - would have properly fallen in the domain of *adaptation*.

Following the decision by the court of first instance, an appeal was filed with the Cour d'Appel (regional court of appeals). The argument presented by the latter went along the following lines. First of all, it considered that contractual practice, following the disruption of the contract's indexing mechanism, indicated that the parties' will was that of keeping their

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111 A. H. Puelinckx, *Frustration, Hardship, Force Majeure, Imprévision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, Changed Circumstances*, 3 J.INT'L ARB. 47, 56 (1986), available at [http://tldb.uni-koeln.de/php/pub\\_show\\_document.php?pubdocid=128100](http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=128100) (last visited Sept. 6, 2007).

112 "The concept requires that (1) the contract be classified as an 'administrative contract'; (2) the event giving rise to the increase in the costs of providing the service has been unforeseeable and external to the parties; and (3) there has been a total upset of the economic circumstances of the contract." (FRICK, *supra* note 50, at 213-14)

113 Cour d'Appel [CA][regional court of appeal] Paris, 1e ch., Sept. 28, 1976, JCP, II, 18810, note J. Robert [hereinafter *E.d.F. v. Shell*].

114 The difference between the two options being the greater manipulative incidence of judicial intervention, with respect to the will of the parties as embodied in the contractual agreement. In fact, C.CIV. art. 1591 requires, for a sales contract to be valid, that the price must be fixed by consent of the parties, or, at least, that it can be fixed by reference to some parameter. Hence, lacking a determination of the price, it wouldn't in theory be possible for courts to supply such missing term.

relationship “alive.”<sup>115</sup> Secondly, holding that the parties had not explored all the possible options for achieving a new agreement on the pricing system, it appointed an observer to help the parties reach such an agreement that would enable E.d.F. to pay an affordable price, while leaving to Shell “a sufficient margin.”<sup>116</sup> Finally, it declared :

[T]hat it is only in a case of failure of these negotiations, and bearing in mind the proposed solution, that the Court will say if the formula which might possibly be suitable from the financial point of view modifies the elements of the current contracts and consequently prohibits the judge from imposing it, or whether, as the parties intended, it restricts itself to adjusting the price to the fluctuations of the market (without altering the economy of the contract) and may therefore be substituted automatically.<sup>117</sup>

In the former case (*i.e.* new indexation formula altering the economy of the contract), termination of the contract by the court of first instance would have then probably been confirmed. At any rate, the parties were able to eventually reach an agreement, so that judicial intervention was no longer required.

### 3. Germany

There are two circumstances in which German substantive law allows courts and, consequently, arbitral tribunals, to adapt contracts.

As for the first case, in the words of a prominent commentator:

[I]t is accepted that the parties include within adaptation provisions, a clause to the effect that the new determination of the [respective] performances should take place by contractual agreement and, in default of it, by court decision. On condition however, that there be in the contract sufficient indications for the determination of performance. A specific [reference] framework should be recognizable, allowing a reasonable integration of the contract. This position is grounded on §315 BGB, which allows to authorize one party to specify the performances after reasonable appraisal [*nach billigem Ermessen*]. Were her determination deemed unreasonable, it would not become binding and could [instead] be made by court decision. [Symmetrically] [s]hould a new contractual ordering not be attained upon resorting to an adaptation clause, the parties would then still be allowed to waive the possibility that performance be specified by one of them and, notwithstanding this, to address the tribunal, competent to issue a decision in second instance.<sup>118</sup>

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<sup>115</sup> Namely, performance was never interrupted, and fuel was delivered against down payment of amounts of money, to be detracted from the price the parties would have later agreed upon.

<sup>116</sup> E.d.F. v. Shell, *supra* note 113.

<sup>117</sup> *Id.*

<sup>118</sup> Fritz Nicklisch, *Die Ausfüllung von Vertragslücken durch das Schiedsgericht [The Filling of Contractual Gaps by the Arbitral Tribunal]*, 1 RECHT INTERNATIONALER WIRTSCHAFT [R.I.W.] 15, 16 (1989)(F.R.G.).

The second adaptation possibility, on the other hand, is that afforded under the doctrine of *Geschäftsgrundlage*,<sup>119</sup> grounded on the idea that “any contract has a basic aim and emanates from a basic intention of the parties which cannot be achieved or realized in the absence of an existing environment, for example, the prevailing economic and social order, the value of the currency, normal political conditions, etc.”<sup>120</sup>

Scholarly theorizations of such doctrine divide into objective and subjective ones. Subjective theories usually refer to the common expectations of the parties, in order to determine the circumstances on whose existence the fulfillment of the basic aim of the contract hinged. Objective theories, on the other hand, purport the need to determine such fundamental circumstances after an inquiry, aimed at ascertaining those conditions whose existence is objectively required for the contract to fulfill its aim.

A modern construction of this doctrine, however, tends to include objective theories in subjective ones: “the relevant circumstances are not limited to those empirically or psychologically proven, but include those that must be included based on a normative analysis which is based on the principle of good faith.”<sup>121</sup>

At any rate, for the deficiency or lapse of the basis of the transaction to justify judicial contract adaptation, it is further required that “under the prevailing circumstances, contract performance cannot be expected.”<sup>122</sup>

#### 4. Switzerland

In Swiss law, the matter of contract adaptation in light of changed circumstances is dealt with under the doctrine of *clausula rebus sic stantibus*. The positive-law basis for such a doctrine is Art. 2(2) of the Swiss Civil Code,<sup>123</sup> on the abuse of right. As a matter of fact, it is believed that the principle of sanctity of contract should be tempered by that of good faith, contrary to which would be to insist on the obligations imposed on the debtor, upon the occurrence of such a change in circumstances that, in exchange for her performance, she will receive either no reciprocal performance or one which is wholly disproportionate.<sup>124</sup>

The conditions under which judicial adaptation may occur under the aforementioned doctrine are fairly restrictive. First of all, it is generally required that the contract with respect to which adaptation is sought be a long-term contract.<sup>125</sup> Further, courts have also inquired on the existence of a subjective element of abuse of the creditor’s right, along with an “obvious

<sup>119</sup> See BGB § 313 (“(1) Should the circumstances, making up the foundation of the contract, materially change after the conclusion of the contract and had the parties not entered into the contract – or changed its content – had they foreseen such circumstances, contract adaptation can be sought . . .”).

<sup>120</sup> Puelinckx, *supra* note 111, at 60.

<sup>121</sup> FRICK, *supra* note 50, at 210

<sup>122</sup> PETER, *supra* note 14, at 191

<sup>123</sup> Schweizerisches Zivilgesetzbuch [ZGB] [Civil code] Dec. 10, 1907, SR 210, art. 2(2) (“The law does not protect a manifest abuse of right.”)

<sup>124</sup> See PETER, *supra* note 14, at 193 (citing II A. VON THUR & A. ESCHER, ALLGEMEINER TEIL DER SCHWEIZERISCHES OBLIGATIONENRECHTS [GENERAL PART OF THE SWISS LAW OF OBLIGATIONS] §74, 170-72 (1974)(Switz.))

<sup>125</sup> See Bundesgericht [BGer][Federal Court] Apr. 24, 2001, 127 Entscheidungen des Schweizerischen Bundesgerichts [BGE] II 300 (Switz.) (“According to the case law parties to long-term contracts must deal with the fact that the existing circumstances at the time of conclusion of the contract are subject to later change. . . . In case the parties expressly or implicitly foresee to exclude the influence of such changes on their reciprocal performances, then it would agree with the essence of the contract that it be so carried out as it had been entered into. Were the supervening circumstances however not foreseeable, then there could be no space for an express or implied waiver of contract adaptation.”). For reference to further judgments, see FRICK, *supra* note 50, at 205 n. 925.

disparity of contractual considerations' resulting from the changed circumstances."<sup>126</sup> Furthermore, there has to be no assumption of risk with respect to changed circumstances, such developments must not have been caused by either party and must have been unforeseeable.<sup>127</sup>

### 5. Italy

Articles from 1467 to 1469 of the Italian Civil Code deal with changed circumstances, with specific reference to contracts that contemplate continuous or periodic performance.<sup>128</sup>

In particular, if, as a consequence of unforeseeable and extraordinary events, performance of an executory contract has become “excessively onerous” for one party, the latter may request termination of the contract - provided no specific allocation of the risk of unforeseen events has been carried out in the contract itself<sup>129</sup> - which the other party may avoid by offering equitable modifications to the aggrieved one.

In case of contracts in which one party only is subject to obligations (the other party having already performed hers, or being solely entitled to rights), the latter may not request termination, but merely file a request for contract adaptation.<sup>130</sup>

### D. Reference Criteria for Contract Adaptation

Assuming applicable procedural law allowed arbitrators to adapt the contract, and that the conditions set forth by applicable substantive law were further met, the problem would then become that of which criteria should guide arbitrators in the adaptation process. Of course, the latter will have to abide by the parameters and goals mentioned within the contract, whenever the parties specified them in their agreement.

Lacking a precise indication of criteria and objectives, it has been noticed in Part I how the generally understood function of a renegotiation clause is that of allowing the restoration of the contract's original economic balance (which we have further identified above in the original division of the contractual surplus). Other commentators have also clarified how “[t]he adopted juridical solution should promote the same objectives of what would otherwise have been successful negotiations,”<sup>131</sup> a solution which is consistent with our approach, once clarified that by “general understanding” of renegotiation clauses it is meant a practice usually followed by legal and market operators, which in turn provides the first and foremost guidance as to what “the same objectives of . . . successful negotiations”<sup>132</sup> would be. A similar reasoning would apply with respect to the District Court's dictum in *Alcoa v. Essex*, affirming the need to provide “a remedy which is suitable to the expectations and to the original agreement of the parties.”<sup>133</sup>

Finally, the comment to Sect. 6.2.2. of the Unidroit Principles - although with reference to the slightly different phenomenon of *hardship* (which requires more than a mere change in circumstances) – also points in the same direction by stating the following:

<sup>126</sup> FRICK, *supra* note 50, at 206.

<sup>127</sup> *Id.* at 207.

<sup>128</sup> See C.C. art. 1467(1).

<sup>129</sup> *Id.* art. 1467(2).

<sup>130</sup> See *id.* art. 1468; II RODOLFO SACCO & GIORGIO DE NOVA, *IL CONTRATTO [THE CONTRACT]* 699 (1996) (Italy) and Alessio Zaccaria, *Art. 1467*, in *COMMENTARIO BREVE AL CODICE CIVILE [CONCISE COMMENTARY TO THE CIVIL CODE]* 1517, 1518 (Giorgio Cian & Alberto Trabucchi eds. 8th ed. 2007) (Italy).

<sup>131</sup> N. NASSAR, *supra* nota 24, at 182.

<sup>132</sup> *Id.*

<sup>133</sup> *ALCOA v. Essex*, *supra* nota 17, at 86.

Another possibility would be for a court to adapt the contract with a view to restoring its equilibrium. In so doing the court will seek to make a fair distribution of losses between the parties. This may or may not, depending on the nature of the hardship, involve a price adaptation. However, if it does, the adaptation will not necessarily reflect in full the losses entailed by the change in circumstances, since the court will, for instance, have to consider the extent to which one of the parties has taken a risk and the extent to which the party entitled to receive a performance may still benefit from that performance<sup>134</sup>

Knowing which goals are to be pursued by contract adaptation has specific relevance to the purpose of determining which circumstances should be considered by the arbitral tribunal. Clearly, the goal of restoring contractual balance primarily justifies consideration of the "original contractual context and agreement,"<sup>135</sup> whereas of lesser importance are, at least in theory, the representations made and positions endorsed in the course of negotiations. In particular, it is believed that proposals and concessions made in the course of negotiations should lose their significance upon failure of the latter.<sup>136</sup> "The reason for such rule is obvious: such proposals and concessions have no purpose other than to allow an agreement to be attained and may well be very far from what each party legitimately considered to be its rights."<sup>137</sup>

After all, were arbitral tribunals to adopt a different attitude with respect to positions taken up during negotiations, the very risk of being held to them even upon failure of renegotiations could yield negative repercussions on the parties' conduct. In response to such risk, they might in fact reduce their flexibility, by displaying less willingness to make concessions to the counter-party to the purpose of finally reaching an agreement.

#### IV. CONCLUSION

It is not possible to give a clear-cut answer to the question of whether, given the insertion of a renegotiation clause in a long-term transnational contract, arbitration may then successfully make up for the parties' lack of agreement. To this end, it is in fact required that the parties' will, the applicable procedural law and the applicable substantive law all converge on enabling contract adaptation by arbitrators. Hence, since there does not exist a single set of options open to the parties confronted with failed renegotiations, it is *de rigueur*, in recounting their steps, to speak of "chronicles," rather than of "chronicle," of a (renegotiation) failure.

In light of this, we wish to stress that each of the steps that have been described throughout the paper is generally open to both a positive and a negative outcome. More specifically - whereas there seems to be widespread agreement on the function and obligations connected to a renegotiation clause - this is very much so, for instance, for the question of the powers of contract adaptation according to applicable procedural law.

First of all, under the traditional construction of the New York Convention, arbitrators should abide by both the *lex loci arbitri* and that chosen by the parties, in order to avoid having their award set aside and consequently becoming potentially unenforceable in any other country.

<sup>134</sup> UNIDROIT Principles, *supra* note 35, art. 6.2.2, cmt. at 191.

<sup>135</sup> NASSAR, *supra* nota 24, at 183.

<sup>136</sup> See Aminoil, *supra* note 25, §59, at 1011 ("a party cannot be held to attitudes taken up in the course of negotiations - involving, as is often the case, concessions and renunciations offered for the sake of reaching an agreement.")

<sup>137</sup> Mobil Oil v. Iran, 16 Iran-U.S. Cl.Trib.Rep. 3, 54 (1987-III).

Secondly, even if the interpretation put forth in this paper is accepted - according to which procedural nationality alone should be relevant for recognition purposes - there might still be cases in which arbitral jurisdiction may not be grounded, according to applicable procedural law, with respect to the submission of conflicts relating to the failure of renegotiations.

Finally, the conditions set forth by applicable substantive law for contract adaptation may vary widely, especially when one considers that the jurisdictions this paper has dealt with are amongst the most “liberal.”

All in all, we believe that the multitude of options parties are faced with *vis-à-vis* the failure of renegotiations could be narrowed down by few, albeit important, adjustments. The arbitrability of conflicts arising from failure of renegotiations is in fact a fertile ground for future legal development, and a fair share of responsibility for such development will rest on the willingness of national legal operators to favor party choice. This will have to be done

- a) by further endorsement of a broad construction of the requirements for grounding arbitral jurisdiction (so as to include mere failures to agree),
- b) by reducing the traditional allegiance to the *lex loci arbitri* for the purposes of recognition and enforcement of foreign arbitral awards, something which - as shown herein - is possible to achieve already at an interpretive level and, possibly,
- c) by introducing, at an international level, uniform criteria for the determination of the applicable procedural law (in default of party determinations on the matter), as has been done for the choice of the applicable substantive law in some contexts.<sup>138</sup>

Only such advancements could, in our opinion, allow to confront parties with a less sketchy and intricate legal framework, in a matter, that of arbitration of long-term transnational contracts, which generally involves conspicuous amounts of money and concerns crucial economic sectors, such as that of fossil fuels and electricity, as many of the cases herein cited have shown.

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<sup>138</sup> For example, see European Communities Convention on the Law Applicable to Contractual Obligations, opened for signature 19 June 1980, 1980 O.J. (L 266) 1, reprinted in 19 I.L.M. 1492 (1980).